Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

October Term, 1996

THE GREENE COUNTY BANK,

Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the term "unsafe and unsound," as used in 12 U.S.C. § 1818(b)(1), means that practices and conditions must have a reasonably direct and adverse effect on a financial institution's overall soundness.

LIST OF PARTIES

Petitioner is The Greene County Bank, an insured state nonmember bank. Respondent is the Federal Deposit Insurance Corporation.

Pursuant to Supreme Court Rule 29.1, Guaranty Bancshares, Incorporated is identified as the parent of The Greene County Bank. Neither Guaranty Bancshares, Incorporated nor The Greene County Bank has subsidiaries.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner The Greene County Bank respectfully requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in this case.

OPINIONS BELOW

The opinion of the court of appeals is reported at 92 F.3d 633 (8th Cir. 1996), and is included in the Appendix at pp. 1a-7a. The decision of the Board of Directors of the Federal Deposit Insurance Corporation and the Administrative Law Judge's Recommended Decision are unreported and are included in the Appendix at pp. 103a-129a and 8a-102a, respectively.

JURISDICTION

The judgment of the court of appeals was entered on August 7, 1996. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

12 U.S.C. § 1818(b)(1) is included in the Appendix at pp. 130a-131a.

STATEMENT AND INTRODUCTION OF THE CASE

This case arises out of an administrative cease and desist proceeding by the Federal Deposit Insurance Corporation ("FDIC") against The Greene County Bank (the "Bank") of Strafford, Missouri. FDIC brought a Notice of Charges against the Bank pursuant to 12 U.S.C. § 1818(b)(1), asserting that the Bank had engaged in "unsafe and unsound" practices in connection with its management of interest rate risk and compliance with an earlier Memorandum of Understanding ("MOU") to which the Bank had agreed in settlement of a prior proceeding also involving FDIC allegations of excessive interest rate risk.[1] An Administrative Law Judge found that the Bank had not engaged in any unsafe and unsound practices that would support a cease and desist order, and that the Bank's high capital, consistent earnings, and overall soundness presented no abnormal risks. The Judge recommended to the FDIC that the proceeding be dismissed. App. 99a.

The Board of Directors of the FDIC, however, disagreed with the Administrative Law Judge and entered a cease and desist order, finding that the Bank had engaged in an unsafe and unsound practice by not complying with the MOU. App. 127a-128a. The Eighth Circuit affirmed, and held, contrary to other circuit court decisions, that an unsafe or unsound practice need not have a reasonably

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[1] Interest rate risk is the potential adverse impact on a bank's earnings by the mismatching of interest rates paid on liabilities (bank deposits) and interest rates earned on assets (bank loans).

direct effect on an institution's overall soundness. App. 6a-7a.

The Eighth Circuit's ruling perpetuates a conflict among the circuits and broadens the FDIC's authority by inviting regulatory interference when actual financial risk to an institution is nonexistent. If left to stand, not only will this ruling subject financial institutions to suffocating over regulation, but it will also result in conflict and confusion over this important financial institutions regulatory issue.

A. Factual Background

The Greene County Bank is a small bank of about fifteen employees with one central office and two branches, headquartered in Strafford, Missouri. The Bank is owned by a holding company of which Mr. Bernard H. Rullman, Jr. and his wife, Joann, are the principal shareholders. The Bank's Board of Directors is comprised of Mr. Rullman, Mrs. Rullman, their son, and two bank employees. Mr. Rullman acts as President and Chairman of the Board of Directors, and has led the Bank's highly successful operations for sixteen years. Although the Bank was strong and well capitalized, it became the subject of criticism by bank examiners, primarily in the area of interest rate risk. As a result, as permitted by 12 U.S.C. § 1818(b)(1), the FDIC filed a Notice of Charges against the Bank on July 26, 1993. The Notice charged the Bank with unsafe and unsound banking practices and noncompliance with the MOU. The Bank denied all the charges, and the matter was heard before an Administrative Law Judge on January 24-27, 1994, in Springfield, Missouri.

B. The Agency Decisions

The Administrative Law Judge issued a 108-page recommended decision on October 31, 1994, recommending that all charges against the Bank be dismissed and the FDIC's request for a cease and desist order be denied. App. 8a-102a. For each specific concern raised by the FDIC, the Administrative Law Judge found that the evidentiary record disproved FDIC's position. For example, the Judge found that the Bank's interest rate risk was well within regulatory boundaries, and upheld all aspects of the Bank's interest rate risk management, including its basic hedging program, its long futures positions, and its investment in an option contract. *Id.* at 20a-21a, 24a-42a, 45a. FDIC's charge that the Bank failed to comply with the MOU was refuted by the Administrative Law Judge's finding that the Bank's regular reports and other submissions fulfilled in all material respects the bank's obligations under the MOU. *Id.* at 30a.

Significantly, the Administrative Law Judge found that the Bank consistently maintained capital in excess of the regulatory minimums – a condition highly indicative of safe and sound banking practices. Clearly impressed with Mr. Rullman and his leadership capabilities, the Judge endorsed the Bank's management and found that the evidence established Mr. Rullman had "successfully managed [the Bank] into a fairly strong institution." *Id.* at 62a. The overall healthy condition of the Bank was repeatedly noted. *Id.* at 9a-10a, 41a, 54a, 56a-57a, 59a, 66a, 69a-71a, 82a.

The Administrative Law Judge's exhaustive review and analysis of the evidence culminated in a finding that

the Bank had not engaged in any unsafe or unsound practices. *Id.* at 97a-99a. Notably, the Administrative Law Judge recognized the legal standard recently adopted and applied by the Third Circuit, requiring a link between the alleged "unsafe and unsound" banking practices and the overall soundness of the institution in order to justify enforcement action under the statute. *Id.* at 53a (citing *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3rd Cir. 1994)). The Judge, however, chose not to address the conflict concerning the legal standard due to the strong factual record establishing that FDIC's cease and desist order was improper even under a definition of "unsafe and unsound" that did not require a link to financial soundness. *Id.*

The FDIC Board issued a 27-page decision and order on August 1, 1995, entering a cease and desist order against the Bank. App. 103a-129a. The Board praised the Administrative Law Judge and claimed to agree with his factual findings, *Id.* at 104a, 107a n.3, 115a, but nonetheless was "troubled" by the "ultimate decision not to issue a cease and desist order." *Id.* at 104a. No attempt was made to discuss in detail the very specific factual findings and legal conclusions entered by the Administrative Law Judge. *Id.* at 118a n.16. Instead, the Board entered a "modest order" in direct conflict with the Administrative Law Judge.[2] The Board, without finding that the Bank's

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[2] FDIC's attempt to portray the cease and desist order entered in this case as a "mild" remedy, while consistent with the Board's description of it as "modest," ignores several important considerations. A cease and desist order may serve as a launching point for several more severe penalties. Additionally, FDIC uses the existence of such an order as a

practices had some reasonably direct effect on its overall soundness, held that the Bank had engaged in unsafe and unsound practices which could result in an abnormal risk of loss. *Id.* at 127a.

C. The Court of Appeals' Ruling

The Eighth Circuit affirmed the decision and order of the FDIC Board of Directors on August 1, 1996. App. 1a-7a. It held that the Bank failed to comply with the MOU and that this was an unsafe and unsound practice.[3] *Id.* at 5a. Although the court acknowledged the other circuit courts' legal standard under the statute for finding a banking practice "unsafe and unsound," it rejected that legal standard in favor of its own contrary formulation. The Eighth Circuit's non-standard gives the FDIC latitude to burden bank management with formal enforcement actions when financial risk is minor, contingent, and remote.

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factor in its ongoing regulatory supervision of the Bank and in its determination of deposit insurance premiums. Each of these matters magnifies the effect of the order on the Bank and the importance of the question presented here.

[3] The court of appeals' decision permits what essentially is record keeping and paperwork, a task having no direct effect on the Bank's overall financial soundness, to trigger regulatory intervention and to heighten the potential for harsher penalties. These kinds of regulatory oversight concerns should be dealt with in the regular examination process, rather than through litigation.

REASONS FOR GRANTING THE PETITION

The Eighth Circuit's holding confers excessive authority upon FDIC to disrupt effective banking policies and to manipulate successful bank management. No one quarrels that the federal government must have flexibility to ensure that banking institutions are sound. However, if the standard by which FDIC is allowed to intercede is not connected to an institution's financial soundness, the FDIC is bestowed with power to regulate at its whim, and in essence, to "fix" what is unbroken.

In these circumstances, it is easy to understand why a number of circuits, in direct conflict with the Eighth Circuit decision here, have interpreted the statutory standard "unsafe and unsound" to mean practices and conditions that have a reasonably direct effect on an institution's overall financial soundness. *See infra* pp. 10-13. This divergence of judicial opinion on an issue that is fundamental to the regulation of the banking industry warrants review by this Court. This case presents the perfect vehicle for resolving the conflict in the circuits and addressing the question of the proper interpretation of the "unsafe and unsound" statutory language.[4]

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[4] A ruling by this Court overturning the court of appeals' definition of "unsafe and unsound" would be dispositive in this case. No question remains as to the Bank's financial soundness and the failure of FDIC to demonstrate that the alleged unsafe and unsound practices had any impact on that soundness. The extensive administrative record establishes that the Bank has a strong history of successful operations, and under present management has never had a loss year. FDIC does not dispute that the net income of the Bank has been steady over time and continues to exceed that of peer institutions. Additionally, as a

Review by this Court is also appropriate due to the need for a uniform standard. The problem demonstrated by this case is magnified by the numerous and diverse circumstances in which the statutory "unsafe and unsound" issue arises. In addition to FDIC, the federal government's four other financial institutions regulatory agencies – the Office of Thrift Supervision, the Office of the Comptroller of the Currency, the Federal Reserve Board, and the National Credit Union Administration – all employ that same standard.[5] Additionally, the standard is implicated in a wide array of financial institutions regulatory actions including officer removal, appointment of conservators, imposition of administrative sanctions, and director and officer common law actions.[6]

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result of the Bank's investment strategy of placing a majority of it assets in government-backed securities with essentially zero credit risk, the Bank has routinely exceeded capital requirements and the capital levels of peer institutions. *See also supra* pp. 4-5.

[5] *See, e.g., First Nat'l Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674 (5th Cir. 1983); *Van Dyke v. Board of Governors of the Fed. Reserve Sys.*, 876 F.2d 1377 (8th Cir. 1989); *Franklin Sav. Ass'n v. Director, Office of Thrift Supervision*, 934 F.2d 1127 (10th Cir. 1991); *Doolittle v. National Credit Union Admin.*, 992 F.2d 1531 (11th Cir. 1993).

[6] *See, e.g., Van Dyke v. Board of Governors of Fed. Reserve Sys.*, 876 F.2d 1377 (8th Cir. 1989) (review of the Board's order removing bank president from his position for his engagement in unsafe and unsound practices); *Franklin Sav. Ass'n v. Director, Office of Thrift Supervision*, 934 F.2d 1127 (10th Cir. 1991), *cert. denied*, 112 S.Ct. 1475 (1992) (savings and loan association accused of engaging in unsafe and unsound practices brought suit challenging decision to appoint conservator for the institution); *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3rd Cir. 1994) (chairman of savings and loan association

Thus, the circuit conflict and the concerns about agency overreaching presented in this case will continually arise as all the regulatory agencies exercise their authority in various banking contexts. The level of regulatory scrutiny should not depend upon the jurisdiction in which an action is filed.

The question presented in this case is whether the court of appeals erred in concluding that Congress intended the statutory standard of "unsafe and unsound" to mean that practices and conditions need not have a reasonably direct and adverse effect on a financial institution's overall soundness. The Eighth Circuit, in affirming the FDIC Board's order, relied on its own prior decisions holding that an " 'unsafe or unsound practice' exists where the conduct is 'deemed contrary to accepted standards of banking operations which *might* result in abnormal risk or loss to a banking institution or shareholder.' " App. 6a (emphasis added) (quoting *First Nat'l Bank of Eden v. Department of the Treasury*, 568 F.2d 610, 611 n.2

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brought petition for review of order imposing administrative sanctions for unsafe and unsound practices); Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability of Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175 (1995) ("unsafe or unsound banking practices serve as a statutory trigger for every important formal enforcement proceeding available against banking directors"); *Resolution Trust Corp. v. Hess*, 820 F.Supp. 1359 (D. Utah 1993) (action brought against former savings and loan directors for negligence and breach of fiduciary duty in connection with various unsafe and unsound loan transactions). *See also*, 12 U.S.C. § 1818(e)(1); 12 U.S.C. § 1813(q)(1); 12 U.S.C. § 1464(d)(2)(A)(iii); 12 U.S.C. § 93; 12 U.S.C. § 1467a; 12 U.S.C. § 1782; 12 U.S.C. § 1786; 12 U.S.C. § 1842.

(8th Cir. 1978) and citing *Oberstar v. FDIC*, 987 F.2d 494, 502 (8th Cir. 1993)). The opinions relied upon by the Eighth Circuit also offered no statutory basis or legislative history for their holdings concerning the definition of unsafe and unsound practices. *Bank of Eden*, 568 F.2d at 611 n.2; *Oberstar*, 987 F.2d at 502.

In contrast to the Eighth Circuit's view of what defines an "unsafe and unsound" practice, the Fifth Circuit has held that "[t]he breadth of the 'unsafe or unsound practice' formula is restricted by its limitation to practices with a reasonably direct effect on an association's financial soundness." *Gulf Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 651 F.2d 259 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982). The *Gulf Federal* opinion discusses the unsafe and unsound standard and reviews its legislative history:

> The "unsafe or unsound practice" provision was the subject of lively congressional concern at the time section 1464(d)(2)(A) was enacted. Several congressmen expressed the view that the "unsafe or unsound practice" formula was too broad and delegated unlimited authority to the Board. *See, e.g.*, 112 Cong. Rec. 25008 (1966) (remarks of Rep. Holifield). The Senate report on the bill noted that the committee had tried to balance the Board's need for flexibility in enforcement against the public's desire to be free of undue federal interference. *See* S. Rep. No. 1482, *supra*, at 3534-35. Representative Patman, the committee chairman and sponsor of the House bill, recognized these fears and admitted that the House committee had been concerned over possible agency abuse of the "unsafe or unsound" provision. 112 Cong. Rec.

24984 (1966) (remarks of Rep. Patman). He nevertheless assured his fellow legislators that "[w]e of the committee are of the opinion that these terms are sufficiently exact and do not involve an overly broad delegation of power to administrative agencies." *Id.*

The breadth of the "unsafe or unsound practice" formula is restricted by its limitation to practices with a reasonably direct effect on an association's financial soundness. As Representative Patman pointed out during the House debate,

> [o]f course, it should be clear to all that the cease-and-desist powers and management removal powers are aimed specifically at actions impairing the safety or soundness of our insured financial institutions. These new flexible tools relate strictly to the insurance risk and to assure [sic] the public sound banking facilities.

112 Cong. Rec. 24984. The authoritative definition of an unsafe or unsound practice, adopted in both Houses, was a memorandum submitted by John Horne, then chairman of the Bank Board. *See* 112 Cong. Rec. 24984 (1966) (remarks of Rep. Patman) (Horne memorandum authoritative in House); *id.* at 26474 (remarks of Sen. Robertson) (Horne memorandum included in record in Senate). Chairman Horne defined the provision in the following way:

> Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders,

> or the agencies administering the insurance funds.
>
> 112 Cong. Rec. 26474 (1966). Chairman Horne listed several practices that fell within his definition. The examples included such management defalcations as paying excessive dividends, disregarding a borrower's ability to repay, careless control of expenses, excessive advertising, and inadequate liquidity. *Id.*

651 F.2d at 263-64; *see also First Nat'l Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674, 681 (5th Cir. 1983) (proceedings limited to practices with a reasonably direct effect on a bank's financial stability).

Influenced by the congressional comments, the *Gulf Federal* court rejected a cease and desist order that bore "only the most remote relationship to Gulf Federal's financial integrity and the government's insurance risk" and "could lead to a minor loss for Gulf Federal." *Id.* at 264. Summarizing its holding, the court stated: "We limit the 'unsafe or unsound practice' provision to an association's financial condition," *id.* at 265, and "the 'unsafe or unsound practice' provision . . . refers only to practices that threaten the financial integrity of the association," *id.* at 267. In this case, the Bank urges this Court to adopt the Fifth Circuit's legislatively supported and well-reasoned standard.

Subsequent decisions of the Ninth and Third Circuits have followed this "unsafe and unsound" statutory standard. In *Hoffman v. Federal Deposit Ins. Corp.*, 912 F.2d 1172, 1174 (9th Cir. 1990), the court reviewed a cease and desist order entered by FDIC against a bank president. The decision affirmed the issuance of the FDIC order by

finding that the president's actions, if continued, would result in an "abnormal risk of loss or damage to [the bank]," and that the actions had a "reasonably direct effect on [the bank's] financial soundness." *Id.* at 1174. In *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3d Cir. 1994), the decision was entered on a petition for review of a cease and desist order entered by the Director of the Office of Thrift Supervision pursuant to 12 U.S.C. § 1818(b)(l). The Third Circuit held that "[t]he imprudent act must pose an abnormal risk to the financial stability of the banking institution" and "[c]ontingent, remote harms that could ultimately result in 'minor financial losses' to the institution are insufficient to pose the danger that warrants cease and desist proceedings." *Id.* at 929 (quoting *Gulf Fed.*, 651 F.2d at 264).

The intended statutory link between banking practices and financial soundness adopted by Congress and recognized by the Third, Fifth, and Ninth Circuits eliminates the fears of regulatory overreaching and provides the proper balance between protection of the public fisc and protection of financial institutions from arbitrary government action. *First Nat'l Bank of Bellaire*, 697 F.2d at 681 (objective is to balance the interests of the government against the interest of banks in receiving fair treatment; the government must not "become so obsessed with protecting the integrity of the national banking system that individual banks are arbitrarily treated unfairly").

Aside from the conflict in the circuits engendered by the Eighth Circuit's holding, the court's sweeping definition of unsafe and unsound practices dangerously allows for abuse of regulatory authority. The Eighth Circuit's

definition essentially destroys the standard altogether. Successful bank management obviously requires some degree of risk.[7] FDIC could legitimately claim that almost all banking practices "*might* result in abnormal risk or loss to a banking institution." App. 6a (emphasis added). As demonstrated by this case, the Eighth Circuit's unsafe and unsound formula allows FDIC to change a bank's procedures, and potentially change a bank's management structure, even though the bank is strong, well-capitalized, and initiating legitimate, successful investment strategies – results Congress feared and sought to avoid. *See supra* pp. 10-12.

The Eighth Circuit approach results in the absurd situation of FDIC having the power to "fix" what is unbroken. The Administrative Law Judge best summarized this view when he stated:

> [The FDIC examiner] expressed a large number of criticisms of the practices of [the Bank], concluding in each instance that the subject practice is unsafe and unsound, and could potentially have an abnormal risk or loss to the bank, to its shareholders, and to the Deposit Insurance Fund.
>
> It is recognized that the logical possibility exists that these criticisms are valid, and the bank could nevertheless be in good shape, but the question does persist of how a bank so riddled with unsafe and unsound practices could

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[7] *See* App. 72a (Administrative Law Judge recognized that a certain amount of interest rate risk is inherent and appropriate in commercial banking).

achieve good earnings, and increase its capital, during an economic recession.

App. 52a.

* * *

Regulatory authorities wield broad power over financial institutions. A cease and desist order affects a bank's policies and procedures, and can be used as an instrument to manipulate bank management. With the government's ongoing use of its financial institution regulatory powers, the issue presented in this case is certain to recur. Only this Court can resolve the problem presented by the Eighth Circuit's aberrational "unsafe and unsound" standard and thereby establish a uniform standard that will bring needed clarity to financial institutions regulation.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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November 1996

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 95-3346

THE GREENE COUNTY BANK, Petitioner,	*	On Petition for Review of Decision and Order of the Federal Deposit Insurance Corporation
v.	*	
FEDERAL DEPOSIT INSURANCE CORP., Respondent.	*	

Submitted: June 14, 1996

Filed: August 7, 1996

Before MORRIS SHEPPARD ARNOLD and MURPHY, Circuit Judges, and JACKSON*, District Judge.

JACKSON, District Judge.

The Greene County Bank appeals a cease and desist order issued by the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC"). The order requires the Bank to comply with a February 12, 1992 Memorandum of Understanding ("MOU") regarding certain activities in the futures and securities markets, and

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* The HONORABLE CAROL E. JACKSON, United States District Judge for the Eastern District of Missouri, sitting by designation.

was prompted by the alleged failure of the Bank to comply with the MOU. The Bank attacks the order as not supported by substantial evidence and as arbitrary and capricious. The Bank also argues that the FDIC applied an incorrect standard in determining that the Bank engaged in unsafe and unsound practices. We uphold the cease and desist order.

I. BACKGROUND

The FDIC initiated an administrative action against the Bank pursuant to 12 U.S.C. § 1818(b) on July 26, 1993 by issuing a Notice of Charges and Hearing. Following a three-day hearing, an Administrative Law Judge ("ALJ") recommended against the issuance of a cease and desist order. Upon review of the ALJ's decision, the FDIC Board found failures of compliance that constituted violations of the MOU and the FDIC Policy Statement as well as unsafe and unsound practices. As a result, the FDIC issued a cease and desist order requiring the Bank to comply with the MOU and FDIC Policy Statement.

II. DISCUSSION

In considering the Bank's challenge to the sufficiency of the evidence to support the cease and desist order, our review is limited to a determination of whether the agency decision is supported by substantial evidence on the record as a whole. *Northwest National Bank v. United States Dept. of the Treasury*, 917 F.2d 1111 (8th Cir. 1990); *First Nat'l Bank of Eden v. Dept. of the Treasury*, 568 F.2d 610, 611 (8th Cir. 1978). Substantial evidence "is such relevant evidence as a reasonable mind might accept as

adequate to support a conclusion." *Culbertson v. Shalala*, 30 F.3d 934, 939 (8th Cir. 1994). In reviewing the agency decision, we consider the entire record, including the ALJ's recommendation. *Simon v. Simmons Food, Inc.*, 49 F.3d 386, 389 (8th Cir. 1995). If the agency departs from the findings of the ALJ, it must show that it gave "attentive consideration" to the ALJ's conclusions. *Id.* at 390.

At issue in this case is whether the process by which the Bank engaged in futures and securities market activities complied with the procedures set forth in the MOU. The MOU requires the Bank to (1) develop written policies for addressing interest rate risk exposure and governing the use of futures to reduce interest rate risk and (2) provide detailed justification each time the Bank uses futures to reduce interest rate risk.[1] The MOU also incorporates the FDIC Policy Statement which, in part, requires the Bank's board of directors to approve any plan to engage in futures market activities. In his recommended decision, the ALJ concluded that the Bank had complied with the MOU in material respects but had not adopted an investment policy in compliance with Section 1(c). The ALJ, however, did not recommend the issuance

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[1] Section 1(a) of the MOU requires the Bank, within 30 days of the date of the MOU, to develop a written plan of action to reduce the bank's interest rate risk exposure. Section 1(b) requires the Bank to adopt a written policy governing the use of futures contracts as a method for reducing interest rate risk which incorporates the requirements of the FDIC Policy Statement. Section 1(b) also requires the Bank to perform specific analyses each time it uses futures to reduce interest rate risk. Section 1(c) requires the Bank, within 30 days of the date of the MOU, to devise an interest rate risk exposure/rate sensitivity policy.

of a cease and desist order. In its reversal of the ALJ decision, the FDIC found that the Bank had in fact failed to adhere to the MOU requirements by engaging in futures and securities market transactions without prior approval by the Bank's board of directors and without proper analysis and documentation. The FDIC concluded that in light of the risks involved in these types of transactions, complete compliance with the MOU was required, and the cease and desist order was necessary to ensure such compliance.

The record shows that the Bank failed to comply with the terms of the MOU and the FDIC Policy Statement when it did not properly document and obtain approval of the acquisition of a number of spread positions. The Bank began acquiring these positions in the Fall of 1992. However, these investments were not formally approved by the Board until March 29, 1993, months after they were made. The only document in the record which contained the Bank's explanation of its strategy for this type of investment was undated. The FDIC concluded that to the extent that any documents contained language that could be construed as authorizing the acquisition of these spread positions, such language was too vague to comply with the requirements of the FDIC Policy Statement. The testimony of the FDIC examiner in charge supports this conclusion.

The FDIC's decision was also based on substantial evidence of deficiencies regarding the Bank's calculation and analysis of interest rate risk exposure. The evidence revealed that the Bank did not calculate and analyze its interest rate risk exposure on a regular basis as the MOU required. Although the ALJ believed that this deficiency

could be excused because the Bank was receiving gap analyses measuring the exposure from the FDIC and other examiners, clearly the terms of the MOU required regular monitoring by the Bank.

After reviewing the record as a whole, we find that the FDIC's determination that the Bank failed to fully comply with the conditions of the MOU is supported by substantial evidence.

The Bank also attacks as arbitrary and capricious the FDIC's decision to issue a cease and desist order. Our review of the remedy imposed by the FDIC to address unsafe and unsound banking practices is limited. The remedy may not be set aside unless it is "arbitrary, capricious, or otherwise contrary to law." *Currie State Bank v. FDIC*, 878 F.2d 215, 218 (8th Cir. 1989). Pursuant to 12 U.S.C. § 1818(b)(l), the FDIC may issue a cease and desist order to prevent a bank from engaging in unsafe or unsound practices. Proof of misconduct alone entitles the FDIC to invoke its broad cease and desist enforcement powers. *Oberstar v. FDIC*, 987 F.2d 494, 502 (8th Cir. 1993).

In this case, the FDIC concluded that the Bank's failure to comply with the MOU constituted an unsafe and unsound banking practice, justifying the issuance of a cease and desist order. As discussed above, the record contains substantial evidence to support the agency's decision. Upon finding an unsafe and unsound banking practice, the FDIC may require a bank to "take affirmative action to correct the conditions resulting from any such . . . practice." 12 U.S.C. § 1818(b)(1). The requirements imposed by the cease and desist order constitute the type of affirmative action that is authorized by the

statute.[2] *See Eden,* 568 F.2d at 611 n.1 (upholding cease and desist order to address the failure to implement internal controls and auditing procedures). Based on the foregoing, we conclude that the choice of remedy by the FDIC in this case was not arbitrary and capricious.

Finally, the Bank argues that the FDIC applied the wrong standard in determining that the Bank's failure to comply with the MOU constituted an unsafe and unsound practice. The Bank argues that application of the "unsafe and unsound practice" standard is limited to practices having a reasonably direct effect on the Bank's financial soundness, a situation not present in this case. *See Matter of Seidman,* 37 F.3d 911 (3rd Cir. 1994); *Hoffman v. FDIC,* 912 F.2d 1172 (9th Cir. 1990); *Gulf Federal Savings & Loan v. FHLBB,* 651 F.2d 259 (5th Cir. 1981), *cert. denied,* 458 U.S. 1121 (1982). It is well-settled in this Circuit, however, that an "unsafe or unsound practice" exists where the conduct is "deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder." *Eden,* 568 F.2d at 611 n.2. *See also Oberstar,* 987 F.2d at 502. We conclude that the FDIC in this case applied the appropriate standard to determine whether the challenged action constituted an "unsafe or unsound practice."

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[2] The cease and desist order requires the Bank, within 30 days of the date of the order, to submit documentation showing the Bank's full compliance with the MOU and FDIC Policy Statement. The cease and desist order also requires the Bank to calculate interest rate risk exposure on a quarterly basis.

The August 1, 1995 Decision and Order of the FDIC Board of Directors is affirmed.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C.

In the Matter of **The Greene County Bank** **Strafford, Missouri** (Insured State Nonmember Bank)	**FDIC-93-160b**

Appearances:

Lynn R. Dadisman, Esq. and *John J. Oldenburg*, Esq. for Federal Deposit Insurance Corporation.

Charles W. German, Esq. and *Brant M. Laue*, Esq. for Respondent.

RECOMMENDED DECISION

ARTHUR L. SHIPE, Administrative Law Judge:

This proceeding was instituted on July 26, 1993, by the issuance of a Notice of Charges and of Hearing (Notice). The proceeding was instituted for the purpose of determining whether an appropriate order should be entered against Respondent under the provisions of section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. § 1818(b).

Oral hearings were held in the matter of January 24, 25, 26, and 27, 1994, in Springfield, Missouri. Post-hearing initial and reply briefs have been filed, and on September 28, 1994, Respondent submitted a supplemental brief, which is hereby received.

Based upon the entire record, including exhibits, witness testimony, and my observation of the demeanor of the witnesses, the following Discussion of Facts and Law, Findings of Fact, Conclusion of Law, and Order, are entered.

DISCUSSION OF FACTS AND LAW

Respondent

The Respondent is a small Bank of about 15 employees with one central office and two branches, all located in suburban Springfield, Missouri. In February 1993, it had assets of $18,798,000, and Tier 1 capital of $1,481,000, with an adjusted equity capital to adjusted assets ratio of 7.9 percent. At the time of the hearing its assets were stated to be $16.5 million. Tr. 619.

The Respondent is largely controlled by Bernard H. Rullman, Jr. It is owned by a holding company of which Mr. Rullman and his wife, Joann are the principal shareholders. Its directors are Mr. Rullman, Mrs. Rullman, their 26 year old son, Tyler Rullman, and two bank employees.

The holding company has accumulated assets besides the bank stock, and is viewed as a possible source of financial strength to the Bank by the Federal Reserve Board. It has no significant debt and owns a securities

portfolio of common stock in unaffiliated organizations with a market value of $313,000, that were acquired at a cost of $185,000. The Federal Reserve Board has recently given the company a composite rating of 2. Resp. Ex. 259.

Bernard H. Rullman, Jr.

Mr. Rullman holds a degree in mathematics, and an MBA in finance, from Indiana University. He was employed by Commerce Bancshares, Inc., a large regional bank, for about seven years, and served as president of two local branches of that firm. He was later employed by Merrill Lynch where he was trained as a stockbroker. In 1979, he purchased the Respondent with borrowed funds which he has managed to repay from its earnings.

The Respondent is well capitalized, and has with the exception of 1991, when its earnings were $24,000, enjoyed adequate earnings every year it has been under Mr. Rullman's management.

However, the Bank has been the subject of various criticisms by examiners in a number of areas, including funds management, interest rate risk and liquidity.

Mr. Rullman was the Respondent's principal witness at the hearing. He is obviously an individual of strong intellectual abilities, and is an astute banker in many respects, who has had extensive and successful experience in the business. However, he seems to listen to his own drummer in banking matters, which has brought him into conflict with the officials having supervisory responsibility for the Bank. A memorandum prepared in connection with the February 1991 examination refers to

Mr. Rullman's continued arrogant and abrasive attitude toward the FDIC examiners during the examination. Resp. Ex. 227.

Respondent's Financial Structure

Beginning in the early 1980s, during a period of high interest rates, Respondent began acquiring securities in the expectation of lower rates. The first purchases were non-callable municipal bonds. With the decline of interest rates, these bonds appreciated in value. Thereafter Ginnie Mae and Fannie Mae mortgage backed securities were bought. As interest rates further declined, and those securities correspondingly increased in value, more purchases were made. None was purchased with a coupon yield of less than 10 percent.

At the time of a 1991 examination by the FDIC, the Bank held over $8.3 million in such securities out of total assets of $19.8 million; appreciation on the securities, not reflected in the Bank's balance sheet was $373,000. In February 1993, this figure was $511,000.

Mr. Rullman viewed the high earnings of the long-term securities and their appreciation as a cushion against possible loan losses and erosion of loan collateral, as well as protection against the risk of higher interest rates, which would increase the short-term interest paid on deposits funding the securities.

Mr. Rullman's views have been consistently rejected by the examiners and other involved FDIC officials. They

have continually insisted that the Bank approach a balanced position of short-term assets and short-term liabilities. Mr. Rullman does not consider this to be a sound investment policy, and claims that his view is validated by the positions of large New York banks, which are said to have substantially increased their long-term assets in recent years to meet risk-based capital requirements.

The 1991 FDIC examination report stated that the Respondent was so liability sensitive that a small increase in the level of interest rates would have a severely adverse effect on its earnings level, leading to possible insolvency if higher interest rates would continue over a prolonged time span.

Prior Proceeding

A Notice of Charges based on the 1991 examination, was issued against the Respondent on August 9, 1991, alleging, *inter alia*, that it was engaged in unsafe and unsound banking practices by failing to maintain an adequate percentage of rate sensitive assets to rate sensitive liabilities, and that this imbalance unduly positioned the Bank in a speculative posture for profit or loss based on interest rate fluctuations.

In its Answer, the Respondent denied the allegations of unsafe and unsound banking practices, and stated that the appreciation of its securities portfolio had a fair market value of over $600,000, and that this protected it from any reasonably foreseeable change in interest rates. Respondent further stated that it had never had a loss year, that it had achieved high earnings in varied interest

rate environments, and had always earned over one percent of assets per year under present management.

In an apparent reference to its then contemplated trading of financial futures, Respondent indicated that it was "taking action to address perceived risks associated with interest volatility and has made this action known to the FDIC." Answer, p. 2.

Future Transactions

The Answer in the prior proceeding was filed on September 6, 1991. On September 9, 1991, Respondent opened a position in financial futures. By September 30, 1991, it had a futures position of 60 short futures contracts on 90-day U.S. Treasury Bills, and 20 short futures contracts on Eurodollars. It had also sold 10 call options on U.S. Treasury Bonds.

Respondent has incurred losses on its futures position of over $500,000 in an 18-month period, more than $300,000 of which was lost between September and December 1991. Respondent continues to maintain a similar short position in financial futures, as well as a smaller long position.

Memorandum of Understanding

On February 14, 1992, the Respondent executed a Memorandum of Understanding (MOU) with the FDIC, and the Missouri Commissioner of Finance, resulting in a discontinuance of the proceeding that had been instituted on August 9, 1991, seeking a cease and desist order. The MOU covered, among other subjects, interest rate risk,

and futures contracts, and included the following provisions:

1. (a) Within 30 days from the date of this Understanding, the Board shall develop a written plan of action to reduce the bank's interest rate risk exposure.

   (b) Within 30 days from the date of this Understanding, the Board shall develop and adopt a written policy governing the use of futures contracts as a method for reducing the bank's interest rate risk. The policy shall incorporate the guidelines set forth in the FDIC Policy Statement entitled, "Statement of Policy Concerning Interest Rate Futures Contracts, Forward Contracts and Standby Contracts," a copy of which is attached to this Understanding. In addition, for each instance in which the Bank engages in the use of futures instruments to reduce interest rate risk, the policy shall require the following:

      (i) Identification of the specific cash market assets or liabilities to be hedged with futures contracts, the amount of cash market assets or liabilities to be hedged and the desired maturity of the hedge;

      (ii) Selection of the appropriate futures contract (Treasury Bills, Eurodollars, etc.) and the establishment and verification, on a monthly basis, of a correlation between (a) the dollar amount

of changes in the aggregate market value of futures contracts and, (b) the change in the fair value of, or the interest income or expense associated with, the item or group of items to be hedged. For purposes of this paragraph, correlation shall be determined in accordance with Generally Accepted Accounting Principles;

(iii) Identification of the exposure of [sic] be hedged, e.g., the potential earnings effect that results from the bank's ratio of rate sensitive assets minus rate sensitive liabilities to total assets ("gap");

(iv) If applicable, determination of the effective cost of the hedge, i.e., the average cost of funds that has been "locked in";

(v) Determination that the futures hedge is a cost-effective alternative compared to other potential strategies to reduce interest rate risk;

(vi) Determination of the proper hedge ratio, i.e., the number of futures contracts needed to cover the identified exposure in the cash market without unduly jeopardizing the bank's capital account;

(vii) Determination, for the number of futures contracts purchased, of the aggregate change in market value of those futures contracts that results from a 300 basis point change in the underlying interest rate of the futures contracts purchased;

(c) Within 30 days from the date of this Understanding, the Board shall devise and implement an interest rate risk exposure/rate sensitivity policy that establishes reasonable parameters, at all time horizons, for both the ratio of rate sensitive assets to rate sensitive liabilities, and the ratio of rate sensitive assets minus rate sensitive liabilities to total assets. This policy could be incorporated into the funds management policy addressed in paragraph 9 of this Understanding.

Allegations and Response in the Instant Proceeding

The instant proceeding was instituted on July 26, 1993, and is based on the 1991 FDIC examinations, as well as subsequent FDIC examinations conducted as of April 3, 1992 and November 1993, and a State of Missouri examination conducted as of March 10, 1993.

This Notice again alleges that Respondent has been operating with improper funds management by failing to maintain adequate percentages of rate-sensitive assets to rate-sensitive liabilities, and by placing excessive reliance on short-term volatile liabilities to fund long-term assets, that Respondent's futures position was taken without

documentary analysis of the effect it would have on Respondent's financial condition, and without compliance with the FDIC Policy Statement on futures transactions. (Statement of Policy Concerning Interest Rate Futures Contracts, Forward Contracts and Standby Contracts," 44 Fed. Reg. 66,673 (1979); amended by 45 Fed. Reg. 18,116 (1980) and 46 Fed. Reg. 51,302 (1981).

The Notice further alleges that Respondent has failed to comply with the MOU, that it has engaged in hazardous investment and trading practices, and that it has operated with management whose policies are detrimental to the Bank, and which jeopardize its deposits.

In its Answer to that Notice the Respondent again denied that it had engaged in unsafe and unsound banking practices, and asserted that its practices and overall condition meet any reasonable definition of safety and soundness. It stated that its securities portfolio had an appreciation of over $500,000, representing a gain of 5.22 percent, which placed it in the top one percent in the country, that it has continued to achieve high earnings in varied interest rate environments, that its current earnings place it in the top one percent of U.S. banks, that it does not speculate on interest rate fluctuations, that its primary equity capital exceeded 9.84 percent. Respondent denied that it has placed excessive reliance on volatile or short-term liabilities to fund long-term assets, and stated that the allegations concerning an alleged imbalance between rate sensitive assets and liabilities on invalid assumptions and insufficient analysis of its financial structure.

With respect to its futures position, Respondent claimed that it was established as a proper hedge of its liabilities, that it had clearly identified the elements of its hedging program in connection with those transactions, that there was a high correlation between its liabilities and its futures contracts, that it had made an analysis of the overall effect of the futures on the Bank, and had complied with the FDIC Statement of Policy on futures. It denied that there was any material potential for significant loss from its futures position, and asserted that losses on its futures contracts were incurred as a hedge of its liabilities.

Respondent denied that it had failed to comply in any material respect with the MOU.

Primary Issues

As the foregoing discussion shows, this proceeding revolves primarily around Respondent's funds management, more specifically its "liability sensitive" position resulting from the use of short-term liabilities to fund long-term assets. It is claimed by the FDIC that although the liabilities would reprice within a short time if interest rates rise, thereby increasing interest expense, there would be no comparable increase in interest income to Respondent to cover the increased expense.

To meet this criticism, Respondent has engaged in futures transactions to hedge its interest rate risk.

It should be noted that the FDIC's main allegation is that the Respondent is operating with an excessive interest rate risk *on a balance sheet* basis. It has not sought to

show that Respondent is in fact now operating with an excessive interest rate risk. In order for that to be shown, the overall interest rate posture of Respondent, including its futures position, would have to be taken into account.

FDIC contends that to include the effect of the futures position would distort the interest rate analysis. It is also alleged that the futures contracts have not been acquired in accordance with applicable standards, or with adequate documentary analysis.

GAP Analysis

Although there are various methods used to determine an institution's interest rate risk, the FDIC examiners primarily use what is known as a GAP analysis.

That analysis entails the categorization of a bank's assets and liabilities by time periods within which they would be expected to reprice in the event of interest rate changes. The time periods are, typically, zero to three months, three months to six months, and six months to one year. The amounts are cumulated for the successive periods. At least 75 percent of an institution total assets and liabilities are expected to be included in this analysis.

Various calculations are then made of the cumulated assets and liabilities for each time period: Liabilities are subtracted from assets to obtain a net position of assets (positive or negative); total assets are divided into the net position figures to derive the net position as a percent of total assets; and assets are divided by liabilities to arrive at a percentage of the former to the latter.

In the absence of explained and special circumstances the examiners expect the percentage of assets to liabilities to be in the 80 to 120 range, though this is not a prescribed standard, and the FDIC has no policy establishing that as a norm.

In order to estimate the effect of an interest rate change on earnings, the combined net position and net position as a percent of total asset figures are multiplied by the interest rate change being measured. This computation is based on the assumption that the assets and liabilities instantaneously reprice and the change is sustained for at least a year.

According to the described analyses in the February 1991 examination, Respondent's assets likely to be repriced within one year were 16.37 percent of liabilities, and the estimated effect on income of a one percent increase in interest rates would have reduced 1990 earnings of $212,000 to approximately $73,000. Corresponding percentages of liabilities to assets for the 1992 and 1993 examinations were 37.4 and 27.

The FDIC recognizes that this test is "simplistic" and has shortcomings in that it does not take into consideration the fact that assets and liabilities may not reprice instantaneously at the same levels and does not consider interest income payment.

Mr. Rullman claims here that the assumption of maturity dates of assets is unrealistic for Respondent because of early repayments, that its Ginnie Mae mortgage backed securities were purchased with coupon yields higher than current interest rates with early payments in mind. The coupon yield reflects the interest rate

paid by the mortgagors who will repay principal faster when their interest rates are higher than current rates.

He also stresses that Respondent's current high earnings, its strong capitalization, and off-book securities appreciation is not reflected in the GAP analysis.

In June 1992, a CPA for IBAA Securities Corporation (IBAA) conducted a study of Respondent that included a GAP analysis showing the effect of its off-balance sheet hedges on its interest rate risk. According to that analysis, Respondent's total position is somewhat asset sensitive rather than extremely liability sensitive, as claimed by the FDIC. FDIC Ex. 30, p. 11.

The FDIC rejects this analysis because it is claimed that the amount used to reflect the impact of the hedge is not explained. This argument is considered below and is found not to be persuasive.

Risk-based Capital and Interest Rate Risk

Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Public Law 100-242, required the Banking Agencies to revise their risk-based capital guidelines to take adequate account of interest rate risk. FDICIA also required the agencies to prescribe final regulations implementing section 305 and to establish transition rules to facilitate compliance with those regulations.

In August 1992, the agencies issued a notice of proposed rulemaking soliciting comments on a possible framework for revising risk-based capital standards to

take adequate account of interest rate risk and other matters.

Based on the comments received from that notice, the agencies issued for public comment a proposed supervisory model that would measure interest rate risk exposure from the effect that a specified change in market interest rates would have on the net economic value of a bank's assets, liabilities and off-balance-sheet positions.

The proposed supervisory model would entail the division of a Bank's assets and liabilities into time bands based upon their remaining maturities or nearest repricing dates. Each time band position would then be multiplied by a "risk weight" developed by the agencies to represent the estimated sensitivity of the economic value of that position to a specified change in market interest rates. The risk-weighted positions of all balances would be summed to produced a net risk-weighted position. That net position would represent the estimated change in the bank's net economic value and would be the primary quantitative measure used to assess a bank's level of interest rate risk.

Under this approach, banks would be required to hold capital for interest rate risk sufficient to cover the "excess exposure," which is defined as an aggregate dollar decline in the net economic value of the institution exceeding a threshold of 1 percent of assets.

Different assets would be accorded varying risk bases. For example, Fannie Mae securities, along with cash and Federal Reserve deposits, would be assigned a zero risk basis. Mortgages on one to four family homes would assigned a 50 percent risk basis.

The dollar amount of capital required would be incorporated into the risk-based capital requirements by increasing the bank's risk-weighted assets. Because the amount of risk-weighted assets forms the denominator of the risk-based capital ratios, any increase to that denominator will lower a bank's measured ratio. Specifically, the dollar amount of the capital requirement for interest rate risk would be multiplied by 12.5, which is the reciprocal of the 8 percent minimum risk-based capital ratio. This amount would be added to the total of the bank's risk-weighted assets for purposes of calculating the risk-based capital ratios.

Mr. Rullman sought to apply the proposed model to Respondent's assets, liabilities and off-balance-sheet positions using the interest rate risk worksheets accompanying the proposal. Resp. Exs. 305 and 306.

According to his computations, Respondent's risk-based capital ratios in the event of an upward move in interest rates of 200 basis points would be 22.53 percent, and 38.98 percent in the event of a comparable downward movement, if the off-balance sheet position is included.

Without that position, the corresponding percentages would be 16.94 and 90.93. As noted, the minimum risk-based capital ratio is 8 percent. It is contended that these computations demonstrate that Respondent does not have an excessive interest rate risk.

The FDIC does not criticize the substance of the methodology used, or the accuracy of the computations, but it points out that the model employed is only a proposal for comment and has not been adopted, and may never be implemented in its present form. The FDIC

also notes that the computations were not made until shortly before the hearing, and thus contends that Respondent could not have previously relied upon this method of determining interest rate risk. Mr. Rullman stated that although the computations were only recently made, he was previously aware of what the results would be. In view of Respondent's high proportion of zero and 50 percent risk based assets and the wide margin by which Respondent's ratios would exceed the required 8 percent, the claim has some credibility.

Respondent argues that it is unfair to proceed against it without regard to the described proposals, and that it is not fair "to evaluate the Bank by admittedly outmoded standards," (the GAP analysis), which place it in the untenable position of contesting this action based on the outmoded standards, while going forward in a regulatory environment governed by up-to-date standards. It cites *Citizens State Bank v. FDIC*, 751 F. 2d 209, 214-16 (8th Cir. 1984) and *In re Pettinari*, FDIC No. 91-248b (Nov. 17, 1992) in support of this argument.

Futures as a Hedge of Interest Rate Risk

Although Mr. Rullman was of the opinion in 1991 that the Bank did not have excessive interest rate risk, after failing to dissuade FDIC officials from instituting a cease and desist proceeding on the issue, he decided to enter the futures market in an effort to hedge the risk perceived by the FDIC. As stated, the FDIC does not consider those contracts to be a hedge against the claimed

interest rate risk, since it argues that they were not properly and prudently acquired in compliance with the FDIC Policy Statement on futures.

Thus, the FDIC continues to maintain that Respondent has a grave interest rate risk, which has not been removed by the futures contracts, while Respondent contends that it does not have an excessive interest rate risk, and that if it did, the futures contracts have removed it.

The FDIC futures Policy Statement contains various general requirements and seven specific requirements pertaining to the use of futures by Banks. It is claimed that Respondent continuously failed to comply with two of the general requirements and three of the specify [sic] requirements.

Among the provisions of the FDIC Policy Statement allegedly not adhered to by Respondent are the following:

> Banks that engage in futures, forward and standby contracts should only do so in accordance with safe and sound banking practices. Levels of activity should be reasonably related to the bank's business needs and capacity to fulfill its obligations under these contracts. In managing their investment portfolios, banks should evaluate the interest rate risk exposure resulting from their overall activities to ensure that the positions they take in futures, forward and standby contract markets will reduce their risk exposure and policy objectives should be formulated in light of the bank's entire asset and liability mix. The following are minimal guidelines to be followed by banks eligible under State law to participate in these markets.

* * *

The board of directors should consider any plan to engage in these activities and should endorse specific written policies in authorizing these activities. Policy objectives must be specific enough to outline permissible contract strategies and their relationship to other banking activities. Record keeping systems must be sufficiently detailed to permit internal auditors and examiners to determine whether operating personnel have acted in accordance with authorized objectives. Bank personnel are expected to be able to describe and document in detail how the positions they have taken in futures, forward and standby contracts contribute to the attainment of the bank's stated objectives.

The board of directors should establish limitations applicable to futures, forward and standby contract positions; and the board of directors, a duly authorized committee thereof, or the bank's internal auditors should review periodically (at least monthly) contract positions to ascertain conformance with such limits.

The bank should maintain general ledger memorandum accounts or commitment registers to adequately identify and control all commitments to make or take delivery of securities. Such registers and supporting journals should at a minimum include:

(a) The type, nature of position (long or short) and amount of each contract,

(b) The maturity date of each contract,

(c) The current market price and cost of each contract, and

> (d) The amount of money held in margin accounts.
>
> * * *
>
> To assure adherence to bank policy and prevent unauthorized trading and other abuses, banks should establish other internal controls including periodic reports to management, segregation of duties, and internal audit programs.

Respondent argues that a policy statement does not have the force of law. However, it should be noted that the MOU requires Respondent's futures policy to incorporate the guidelines contained in this Statement of Policy.

Board Approval of Policies

FDIC contends that the futures contracts were acquired without board approval, and that adequate policies and limitations on the trading of futures have not been established by Respondent's board. The record contains a number of documents, which Respondent claims, refute these allegations, but the FDIC argues that these documents are seriously flawed.

On April 23, 1991, Mr. Rullman presented to the Board of Directors proposed revisions to the Bank's Funds Management and Investment Policy to include as authorized investments for the Bank, among other financial instruments, interest rate futures. Secretary of the Board Owen moved for the adoption of the revised policy, and upon the second of Joann Rullman, the motion carried. FDIC Ex. 31, p. 30.

As pertinent here, the revised policy reads as follows:

> Earnings are a vital and necessary component of the investment portfolio. A high yielding portfolio will provide greater growth in capital and the income will itself provide liquidity. To increase earnings, the Bank selectively mismatches asset and liability repricing. The size of the asset/liability mismatch depends on a careful assessment of the inherent risk that interest rates may not move as anticipated. The Bank shall maintain the flexibility to change any mismatch quickly by capital markets instruments mechanisms such as interest-rate futures, swaps and future rate and purchase agreements up to an amount equal to the total of investments and loans. The responsibility for developing strategies and tactics for achieving the Bank's Asset/Liability Management rests with the Asset/Liability Committee (ALCO).

FDIC Ex. 16-b-2.

This statement of policy seems to set forth a rationale for Respondent's mismatch of short-term liabilities and long-term assets, and the use of futures in connection with this mismatch, and limits the latter "to an amount equal to the total of investments and loans." This would comprise the majority of the Bank's total assets, which were $19,867,000, as of February 26, 1991.

The FDIC Examination Manual suggests that interest rate futures may be used "to hedge against unprofitable fluctuations in interest rates when imbalance exists in a bank's rate sensitivity position." FDIC Ex. 1-a, p. 5.2-1.

On June 27, 1991, the board passed a resolution, on motion of Mr. Owen, and seconded by Mrs. Rullman,

approving the execution of customer agreements by the Bank with several brokerage firms for the purpose of trading various financial instruments, including futures. FDIC Ex. 31, p. 34.

As stated, the first purchase of futures contracts by Respondent occurred on September 9, 1991. On the following day, the subject was discussed at the board meeting. The minutes of the meeting state, "Chairman Rullman presented the bank's hedging position. (See supporting documents in file.)" According to Mr. Rullman he explained to the board the basics of how the futures hedge would work. The supporting documents consist of a section from the Wall Street Journal containing the price listing of the involved futures and a sheet setting forth futures acquired, the number acquired, the price, value "per tic" ($25.00) per contract and for the position. FDIC Ex. 31-b.

The FDIC argues that the minutes do not support Mr. Rullman's description of the discussion that took place at the meeting, that his account is uncorroborated, and that there is nothing in the minutes evincing approval of the contracts entered on the previous day, or of those entered on subsequent days.

There is no basis for disbelieving Mr. Rullman's version of the meeting, which is somewhat corroborated by the documents referenced in the minutes. There is no explicit approval of futures activity recorded in the minutes. In view of the prior adoption of a policy embracing the possible use of futures, the authorization to open a futures trading account, and the later board action, it can scarcely be contended that this activity was not

approved, though the minutes should have explicitly so indicated.

The October 1991 board minutes state that "Chairman Rullman reviewed the current status of the bank's hedging program." At that time there were 80 futures contracts open.

Following criticisms of its hedging program by FDIC Examiner Julia Poitevin during a visitation in October 1991, Respondent engaged Peat Marwick to assist it in developing policies to govern its hedging program. Pursuant to that engagement a proposed policy statement was furnished.

At the December 30, 1991 meeting, the Board of Directors adopted a revised policy on Asset Liability Management, and established the membership of a Asset/Liability Management Committee (ALCO). The adopted policy delegated "responsibility to ALCO for the formulation, revision and administration of appropriate policies. FDIC Ex. 31, p. 43. The membership of the ALCO was the same as that of the Board, except for Tyler Rullman, who was not included on the ALCO. A portion of the policy statement authorized ALCO to use financial futures, and included much of the language contained in the Peat Marwick document. This language was subsequently included in the MOU and is quoted above. FDIC Ex. 16-b-5.

FDIC claims that the requirement of the MOU that the futures policy incorporate the guidelines of the FDIC Policy Statement on this subject was not complied with. However, the substance of those guidelines was adopted in detail.

Beginning in January 1992, the ALCO became the official body responsible for policies and oversight of the futures program. Although its membership was virtually identical to that of the Board of Directors, since April 1993, the board approves *qua* board the minutes and actions of the ALCO. The Bank's futures position has been consistently reviewed by ALCO and the board.

Limitations

Respondent relies on computations contained in the February 23, 1992 ALCO minutes as establishing the limits, and the basis therefor, of its futures trading.

The record includes an unsigned copy of those minutes, as well as a corrected copy of the signed minutes. FDIC claims the minutes were "altered." The changes consist of corrections of arithmetic, and the substitution of one sentence for another. Although it would seem that the changes should have been officially approved by a subsequent ALCO meeting, in view of the nature of the alterations they are not relevant to the substantive matters in dispute here.

The corrected minutes contain the following table.

Liability	Amount	Time in Quarters			Contracts
N.O.W.	$2,180	X	4	=	8.92
1 Year C.D.	3,604	X	8	=	28.83
6 Month C.D.	6,710	X	8	=	53.68
Savings	1,320	X	4	=	5.28
M.M.I.	3,170	X	8	=	25.36
TOTAL					122.07

FDIC Ex. 32, p.2.

The dollar amounts state Respondent's liabilities in thousands, and the numbers 4 and 8 under Time in Quarters refer to futures contracts on Treasury Bills or Eurodollars.

Immediately below this table the minutes state:

> The above calculation was determined to effect 100 percent hedge position. The committee discussed the desirability of a total 122 contract hedge and decided that the partial hedge of 80 contracts would, if not totally, reduce the effects on the Bank liabilities sufficiently to protect from loss the repricing of the liabilities.[1] Currently the strong earnings of the bank were in line with the attached report of The Effects of Repricing and Changes in Interest Rates and the Futures Hedge for The Greene County Bank in 1992.

The referenced contracts are 90-day U.S. Treasury bill and Eurodollar futures. The 90-day Treasury bill has a face value of $1 million. It does not have a coupon rate. The interest rate is determined by the amount of discount from the face value at which the bill is traded. Thus, a bill sold at issuance for $985,000 (or 98.5 percent of 100 par) will earn 6 percent on an annualized basis, or $15,000 (one fourth of $60,000, the annualized return at 6 percent) Resp. Ex. 241, p. 7; FDIC Ex. 16-b-1, p.2.

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[1] A prior version of the minutes reads: "At this time it was determined that eighty (80) contracts were sufficient to protect against interest rate risk." The number required for a total hedge is incorrectly computed as 100 contracts.

The futures contract is an obligation to make or take delivery of the Treasury bill by a maturity date. (In practice, delivery does not ordinarily occur – the contract is closed by the purchase or sale of an opposite position.) The arithmetic applicable to the principal and interest of the bill applies to the future contract from which it is derived. A movement of one percent in the interest rate of the bill will affect the value of the contract by $2,500 ($1,000,000 x .01 ÷ 4). Therefore, to hedge an amount of deposit liabilities for one year will require four times that amount in future contracts on 90-day T-bills. This is known as the stack method of hedging. Tr. 497, 665, 779; FDIC Exs. 16a, p. 26 and 16-b-1, p. 2; Resp. Ex. 241, p. 7. The same principles apply to the Eurodollar futures, which are based on dollars deposited abroad.

The foregoing computations are also worked out in a document entitled "Greene County Bank Interest Rate Strategy." That document states that to fully hedge the Bank's liabilities for one year would require 70 contracts.

The FDIC contends that there is a conflict between the two computations, and that it is impossible to ascertain whether the limitation is 70 contracts to effect a full hedge for one year, or 80 to effect a partial hedge for longer periods. The FDIC also points out that the earlier April 1991 authorization was based on investments and loans.

Mr. Rullman stated that the Interest Rate Strategy calculations are illustrative of the manner by which the number of hedged contracts are determined, and that the ALCO minutes contain the Bank's limitation on the

number of contracts to be used. His statement is supported by the language of the Strategy document, which states for instance, that 70 futures "*would* result in the number of futures necessary to hedge the bank's liability position for a period of one year . . . and that a "higher ratio *would* be necessary to adjust for a security which does not correlate exactly 100%." (Emphasis added) The April 1991 bank policy specifying limits in terms of assets was superseded by the subsequent decision to hedge liabilities.

Mr. Rullman gave this explanation of the reasoning underlying the computations by which it was determined that some of the liabilities should be hedged for a period longer than one year:

> We took each liability that was to be hedged and determined a time based upon its sensitivity to interest rates for which we wanted to hedge it. We determined that NOWs and Savings were less subject to interest rate changes than the one-year CD, the six-month CD, and the money market investment accounts. So we applied a higher time period, a two-year time frame for the one-year CD, the six-month CD, and the money market account, and left the NOW and Savings at one year. We performed the calculation that came out that if we had a total hedge based upon the liability, total liabilities at that time, that the total would be 122.07 contracts. Since we were limited by the Memorandum of Understanding, we left the contracts at 80, which left our agreed-upon calculation of capital, plus the 70 percent security appreciation, minus a 300 basis point shift in interest rates

reduction from the futures contracts at a comfortable level above 6 percent.

Tr. 734.

The referenced provision of the MOU required the Bank to maintain Tier 1 capital of 6 percent plus an amount equal to a possible 300 basis point loss on its futures position, less 70 percent of the net unrealized gains on its securities. Paragraphs 1(b)(viii) and 11(a)(2).

It is concluded that the discussed ALCO minutes do establish limitations on the amount of short futures contracts that may be employed by the Respondent to hedge its liabilities.

Identification of Risk

In April 1991, when Respondent first adopted a policy on the use of futures, which was about five months before the first contracts were sold, it appeared to contemplate using futures as a hedge for assets. FDIC Ex. 16-b-2.

When Examiner Poitevin conducted a visitation examination in October 1991, after the first 80 contracts were sold, Mr. Rullman was still uncertain whether the futures were considered to be a hedge for assets or liabilities. FDIC Ex. 8-b. The effect of the hedge on the securities portfolio was being considered. FDIC Ex. 8, p. 11 and 10-a.

It seems undisputed that given Respondent's position, heavily structured toward long-term assets and short-term liabilities, the effects of a general increase in interest rates would be to reduce the value of the long-

term assets, since their value is related inversely to interest rates, as well as to increase the cost of funds used to finance those assets.

To hedge either the value of the assets or the cost of liabilities against the risk of increased interest rates would entail the acquisition of financial instruments that increase in value with an increase in interest rates, and thus offset the higher interest paid on deposits, and the depreciation of assets. Thus, the same futures instrument could be used to hedge asset value or liability costs.

In October 1991, Respondent made a commitment to the FDIC to engage Peat Marwick, who was its outside accountant, to provide assistance in developing a hedging program. That assistance included a determination of whether the Bank should be an asset or liability hedger. This decision rested to some extent on tax considerations; the tax exempt status of municipal bonds might be lost if they were hedged. Tr. 682.

Before the end of 1991, Respondent determined, in consultation with Peat Marwick, that it would be a liability hedger. Peat Marwick made an interest rate futures correlation analysis comparing changes in Respondent's liability expenses in the form of interest paid on deposits with changes in the interest rates earned on 3-month treasury bills and Eurodollars, and found that a significant correlation exists between the changes in rates paid for deposits and rates reflected in futures on the treasury bills and Eurodollars. This correlation is confirmed by regression analyses that have been regularly computed by Mr. Rullman, and does not seem to be disputed here by the FDIC.

However, the FDIC points out that this correlation, though necessary for a proper hedge, does not establish the amount of risk to be hedged. As shown above, Respondent claims to have hedged its deposits in the approximate amount of $17 million for either one or two years.

In order for a hedge to work properly, losses on the hedge instrument should be offset by gains on the items being hedged. Respondent has sought to show that it has in fact recouped savings on interest expense to offset losses on its futures transactions. In an attempt to comply with Paragraph (b)(ii) of the MOU, Mr. Rullman prepares a report monthly for the ALCO setting forth cumulative changes in interest expense and the Bank's futures position. Resp. Ex. 272. The results are presented in graph form here for 1992, and for January through June of 1993. Resp. Ex. 273.

For those periods losses on the futures were under $200,000, while cumulative savings on interest costs were nearly $500,000.

The FDIC contends that this comparison is misleading because the amount of deposits declined 19 percent during 1992, and interest payments accruing from a shrinkage of deposits should not be offset against losses on the futures position. FDIC further argues that since Respondent purported to only effect an approximate 65 percent hedge (80 contracts out of 122 for a full hedge), it is not appropriate to compare future losses with all savings on interest costs. These criticisms would suggest that the cumulative interest savings are over-stated. However, if that is the case, and they were lower, the correlation

between such savings and future losses would be closer than that depicted.

The FDIC has presented graphs on interest savings on deposit and losses on futures separating the results for 1992 from those of 1993, January through October. FDIC Ex. 28, pp. 4 and 5. The 1992 graph is similar to that introduced by Respondent. The 1993 graph shows that savings on interest expense continued, amounting to about $40,000, that losses on Respondent's futures position amounted to less than $10,000, and widely fluctuated during the year. These results were largely caused by the purchase in 1993 of long contracts on treasury bills, an activity that is also criticized by the FDIC, and discussed below.

Respondent's futures trading was based upon the total amount of its short-term liabilities. Although a tight correlation between interest rates on those liabilities and the 3-month treasury bills and Eurodollars, which is reflected in the utilized futures, was demonstrated, the FDIC continues to insist that Respondent has failed to undertake any analysis to determine whether the losses experienced on its futures contracts would be offset or recovered from some other source of income.

It is concluded that this allegation has not been sustained, and that the level of futures trading has been shown to be *reasonably* related to the Respondent's business needs and capacity to fulfill its obligations under those contracts. Despite losses on the futures, Respondent has, with the exception of 1991, when losses on the futures were taken before the effect of repriced deposits

occurred, continued to maintain sufficient earnings. Without the savings on deposit interest this would not have been possible. To maintain that no relationship has been shown to exist between interest expense saved and losses on future is to ignore substantial data.

Respondent is criticized for its assumption, for purposes of futures calculations, that a one percent increase in interest rates will affect all of its deposit liabilities by one percent. While it is an assumption, it would seem to be a necessary one since it cannot be determined in advance what specific interest rates may be required to attract deposits if those rates change.

Similar assumptions are included in the GAP analyses presented by the FDIC. There the assumption is that an institution's assets and liabilities subject to possible repricing within one year will reprice concurrently at the same levels. To show the income effect for a given change in interest rates assumes that all assets and liabilities in the zero to 12 months bracket reprice instantaneously, and that the rate is sustained for a year. Tr. 105, 108, 165, 168; FDIC Exs. 2-d and 3-e.

In positioning a hedging model depicting the relationship between changes in interest expense and interest rates it is assumed that repricing occurs at 3, 6, and 12 month intervals with the various deposit instruments. Tr. 211-222; FDIC Exs. 2-f, 2-g and 6-d.

All of the foregoing assumptions, as well as the hypothesized one percent interest rate movement that is sustained for one year, may be useful, but they do not necessarily reflect events that occur in practice. Given the demonstrated use and necessity of assumptions as to the

effects of possible interest rate changes, it has not been shown that the assumptions as to the effects of possible interest rate changes on Respondent's liabilities is unreasonable.

Implicit in the FDIC's criticisms of Respondent's claimed liability hedge is the apparent premise that any hedge of interest rate risk should be confined to the gap between short-term assets and short-term liabilities, and that to the extent that increased interest expense can be expected to be offset by an increase in earnings from loans, the increase in expense cannot legitimately be hedged. There is no authoritative statement cited for this assumed restriction.

The Policy Statement requires that levels of future activity be *reasonably* related "to the bank's business needs," that futures activity reduce "interest rate risk exposure" and that "policy objectives should be formulated in light of the bank's entire asset and liability mix." The Examination Manual contains similar language. The stated premise does not follow from these policies.

The futures trading program of Respondent has clearly been formulated in connection with its business needs and in light of its entire asset and liability mix. Respondent's asset and liability mix includes relatively large amounts of securities, having an appreciated value far higher than their book value. The assets are financed by short-term deposits. As previously stated, an increase in interest rates would tend to reduce the appreciation in the securities and increase the cost of the liabilities. An increase in interest rates would generate offsetting income from the financial futures.

The FDIC insists that Respondent has not evaluated the full implication of its futures transactions. However, it construes any reference to their offsetting effect on the value of assets as indicative that the futures are not really hedges at all. Similarly, it deems any reference to the tax consequences of the futures position as negating the claim that the futures are a hedge.

Respondent's adequate earnings, despite significant losses on its futures contracts, would indicate that it has the capacity to fulfill its obligations under those contracts.

Despite the foregoing, the FDIC, citing Examiner Poitevin's testimony, argues that from September 1991 through October 1993, this $20,000,000 Bank acquired futures contracts aggregating approximately $500,000,000 for the ostensible purpose of reducing a risk it had never identified. Brief at 45.

The FDIC seems to insist that unless interest rate risk is derived through some form of a GAP analysis it has not been identified. As stated, it also rejects a GAP analysis prepared for Respondent by a CPA because that analysis allegedly included an insufficiently explained effect of the futures position. FDIC Ex. 30.

An amount of $20,000,000 was included in that analysis to show the impact of hedging. This was manifestly an allowance for the "stack" effect of 90-day instruments, previously explained. Eighty contracts on 3-month futures contracts would equal $20,000,000 for one year.

As the FDIC points out, this firm recommended that consideration be given to reducing the number of T-Bill

contracts used by Respondent to hedge its liabilities. It suggested that 40 contracts were needed to hedge a gap of approximately $10 million or four contracts for each $1 million, which is consistent with the formula used in its GAP analysis. The questioned use of the $20,000,000 figure in that analysis is not justified.

Even if interest rate risk can only be determined through an accepted GAP model, Respondent had available to it the analyses performed by the FDIC and State examiners, as well as IBAA. FDIC argues here that since Respondent disagrees with these analyses they do not satisfy the requirement that risk be identified.

The arithmetic in these studies is not questioned by Respondent. Its claim is that the results do not demonstrate that the Bank's financial viability would be jeopardized by an increase in interest rates. The futures contracts were sold in an effort to oblige the contrary views of the FDIC. It seems incongruous for the FDIC to now insist that acquisition of the futures position was improper because Respondent has not performed the tests repeatedly conducted by its examiners.

Long Contracts

As previously noted, the price of treasury bills and futures thereon varies inversely with interest rates. A rise in interest rates will lower the price of the bills and futures. Therefore, to hedge against a possible rise in interest rates the hedger goes short in the futures market. He will obtain a profit if interest rates rise because the price of his futures declines.

Also, as noted, treasury bills are traded at a discount to their face value, the amount of the discount being determined by the applicable interest rate. At maturity the bill is worth its face amount, $1,000,000. Its value increases as the time to maturity shrinks. The price of the futures reflects the value of the bill. If interest rates remain steady the price of the futures increases as it moves toward expiration because of the shortening of time before the underlying bill reaches maturity and becomes worth its face value. The result of the foregoing is that a short position on a treasury bill will lose money as the future contract moves toward expiration with no change in interest rates. Conversely, a long position will gain money.

Respondent's futures contracts were short, and thus subject to losses when held over time as they moved toward expiration. Considering interest rates to be low and stable, Mr. Rullman developed a plan by which the Bank would establish a long position in futures that would partially offset expected losses in its short position. FDIC Ex. 21-b-5. It was found that more distant future contracts trade at a higher percentage discount to par, and that the gain on 40 long contracts, expiring later than the short contracts would largely offset losses on 40 short contracts against which the longs were spread, as well as recoup the costs incurred on an additional 80 short contracts. At the time of the State examination in March 1993, Respondent had acquired 40 long contracts, and 120 short contracts, for a net position of 80.

By thus trading longs and shorts Respondent made about $100,000 on long contracts in 1993, and virtually eliminated the cost of the hedging program.

The long contracts were bought to generate income to offset losses being incurred on the short contracts. Though related to the hedge, the long contracts did not hedge a balance sheet item. They were hedges of the short futures hedge.

The strategy for trading longs was formally approved by the ALCO on March 29, 1993.

It is unclear whether the FDIC Policy Statement covers this type of activity, or if it is deemed "speculative" and if so, whether it is permissible for banks. The FDIC Manual of Examination Policies states: "Speculation in futures contracts is generally not an appropriate bank activity. However, this type of activity may be acceptable as part of a trading function by a sophisticated institution which has adequate capital, sufficient internal controls and management expertise." p. 5.2-10. Presumably, Respondent is not described there, though the strategy used evinces some sophistication in the use of futures to generate income.

In reference to the required board policies on futures trading, the Examination Manual states, "The policy should include gross and net limits pertaining to each permissible contract." p. 5.2-10. This seems to refer to the type of trading in issue here.

As indicated, the strategy is stated to be confined to an environment of steady and low interest rates. The risk of loss on the longs is that interest rates will rise. Since they are spread against the short position on similar instruments, with a moderate difference in time, losses on the longs would be expected to be offset by gains on the shorts. The actual risk is that this will not occur. That risk

would seem to be less than the risk inherent in the matching of interest rates and maturities of assets and liabilities in conventional banking practices.

Internal Records and Control

FDIC claims that there were no internal audit procedures for the Bank's use of futures. Using a spread sheet, Mr. Rullman developed on his personal computer a monthly report for the ALCO. That report contains a list and description of open futures contracts, the price at which they were acquired, the current settlement price, the value of the position, the value of a minimum movement in price per contract and per position, the trading results for the year, and current month, and the change in value of the position resulting from a 300 basis point change in interest rates.

The current reports also include a running comparison of changes in interest rate expenses on deposits and losses or gains on the futures positions, as well as a regression analysis of the relationship of those changes. Resp. Ex. 279.

The futures broker furnishes comprehensive monthly reports on the Bank's futures position. These are reviewed by ALCO and the Bank's board. Tr. 803-806.

Upon request for direction by Respondent, Peat Marwick suggested that two general ledger accounts with subledger accounts, and two accounts for the income statement be established for the futures program, and these were established as recommended. Tr. 718-719; Resp. Ex. 247.

The dominant role of Mr. Rullman in the trading of futures contracts is a matter of legitimate concern to the examiners.

Paragraph 10 of the FDIC Policy Statement on futures states:

> To assure adherence to bank policy and prevent unauthorized trading and other abuses, banks should establish other internal controls including periodic reports to management, segregation of duties, and internal audit programs.

It is obvious that this policy statement is directed at larger institutions where any futures trading is conducted by lower echelon personnel.

The Examination Manual states that a Bank's policy on futures should delineate trading authority, and that this authority "should be delegated only to individuals which demonstrate the specific knowledge and expertise necessary to properly transact those permissible activities and strategies in a safe and sound manner." p. 5.2-10.

The literal applications of the Policy Statement requirement to Respondent is impossible since its trading is done by top management. As noted, consistent reports are made to the board on all the trades and their status. Though it might be advisable for there to be a sharing of duties among management with respect to this futures activity, the feasibility of a bank of 15 employees having different persons adept in trading futures is not established.

Futures trading confined to top management, subject to constant oversight by the board, accomplishes for a bank as small as Respondent the objectives of paragraph

10 of the Policy Statement in assuring adherence to bank policy, the avoidance of unauthorized activity, and the restriction of trading to the most competent persons available.

Naked Options

On September 13, 1991, Respondent sold 10 call options on U.S. Treasury bond futures. It received a premium of $8,065.95 for the sale. The transaction obligated Respondent to deliver bond futures to the holder of the options upon exercise of the options. The options would be exercised only if the involved futures price increased to an amount over the strike price specified in the option. (I am unable to ascertain the strike price from the account statements. Resp. Ex. 281). A rise in the futures price would occur if interest rates were to decline. The option buyer is willing to pay a premium for the possibility that this will occur. The seller by receipt of the premium is exposed to the risk of lowering interest rates. There is no specified limit to the amount of loss that may be incurred. It may exceed the amount of the premium.

Since it did not own the bonds, or futures thereon, these options are termed "naked." The Examination Manual states, "Selling uncovered or naked options is highly speculative and has no place in a bank's investment program." p. 3.2-9.

Respondent contends that these options were covered by its securities investments since any loss on the options would result from a decline in interest rates which would simultaneously increase the value of its

securities. This does not meet the requirements of a covered option. Early in his discussions with regulators Mr. Rullman pledged not to engage in any additional transactions of this nature, and none has occurred since the one sale of the 10 options in September 1991.

REMIC

The Notice alleges that on February 11, 1992, the Respondent Bank purchased a Federal National Mortgage Corporation Real Estate Mortgage ("REMIC") in the amount of $150,000, that this was an unsafe and unsound banking practice in that it was acquired without documentary evidence in the Banks' records of any analysis and its financial effect on the Bank, or of compliance with an FDIC policy statement entitled, "Supervisory Policy Statement on Securities Activities," 57 Fed. Reg. 4029 (1932). This Statement became effective on February 10, 1992, the day before the purchase in issue.

The Notice alleges specifically that the REMIC was acquired without documentation criteria established by the board on the use of REMICs, and without documentation of whether the instrument was a "high-risk mortgage" security. It is further alleged that as of April 3, 1992, the Bank had suffered a loss of $2,000 on the purchase.

In its Answer, Respondent denied that the purchase was unsafe and unsound, and asserted that a proper analysis had been made, and that the Policy Statement had been complied with in all material respects. It denied that it had suffered any loss on the transaction and stated that it had already been paid off in accordance with the

projections in the prospectus which were available to the FDIC examiners.

It will be noted that it is not alleged that the purchased instrument was a high risk investment, or that no analysis thereof was made. The allegations are that documents pertaining to these matters were not created.

There is conflicting testimony pertaining to whether a relevant prospectus was obtained by the Bank prior to its purchase of the REMIC. As indicated, Respondent claims that it was, and that it was furnished to the examiners during the April 1992, examination. Tr. 722. Examiner Poitevin testified that Mr. Rullman stated at that time that he did not have the prospectus prior to the purchase. Tr. 299-303. There are notes by another examiner confirming her testimony. FDIC Ex. 16b-12.

Mr. Rullman, on the other hand, produced the prospectus with some notes that were stated to have been made prior to the purchase referring to alternative pay out times. Resp. Ex. 239, p. 5-38.[2] It is not possible to

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[2] The examiner's note states, in part:

> When questioned about compliance with the Statement of Policy, he said, "Well, let's just go through it item by item." I told him it was quite comprehensive and he then said that his analysis was limited to the fact that
>
> 1) Securities have paid off in 2 years and
> 2) Solomon Bros. estimated it to be 145-170 range.
>
> Mr. Rullman's note on the prospectus reads: 150 2.08 135 3.5.

reconcile the conflicting testimony on the matter. However, I am unable to ascribe fabrication to either side, but conclude that it was an unfriendly exchange and that the conflict reflects a miscommunication or a misunderstanding.

Both the examiner notes and those in the prospectus refer to an expected pay-off of the bond within two or three years. The applicable test which, it is claimed, was not shown to have been performed, is a price sensitivity test to determine if the value of the bond would change more than 17 percent with a shift in interest rates of 300 basis points. Mr. Rullman contends it is readily obvious that the value of an instrument paying off within two of three years could not change by 17 percent with a three percent change in interest rates. He gave his reasoning on this at the hearing. It was credible and has not been refuted. Tr. 946-947. The results were confirmed by an analysis by IBAA in June 1992. FDIC Ex. 30, p. 65.

The following conclusions can fairly be drawn with respect to this transaction. It was not a high risk instrument. Mr. Rullman determined this to his satisfaction prior to the purchase. The notes evidencing his analysis are cryptic, but reflect an acquaintance with the essentials and nature of the specific investment as well as related concepts. It is doubtful that all of this could have been conveyed solely by oral communications with the broker.

The numbers 145-170, 150 and 135 refer to the Public Securities Association's standard prepayment model (PSA) and represents an assumed monthly rate of prepayment. Resp. Ex. 239, p. S-6. The numbers 2.08 and 3.5 state in years the expected life of the security.

There was no investment policy specifically authorizing this purchase, but it was within the guidelines that were in effect. It was paid off within a year, without any loss to the Bank.

Liquidity

It is contended by the FDIC that Respondent's method of funding possible liquidity needs is unsafe and unsound. It is not claimed that the Bank is illiquid in the sense that it could not readily convert its assets into cash. Its large holdings of marketable securities could either be sold, or used as collateral for borrowings.

At the time of the hearing Respondent had unsecured lines of credit at two banks for $600,000 each, credit at the Federal Reserve Bank for $300,000, and securities pledged at another bank for potential drawing of credit of over $3.5 million. It had securities of about $8 million.

FDIC argues that the risk posed to Respondent stems from a potential increase in interest rates, resulting in more costly deposits, or borrowing to fund assets. If longer-term higher yielding assets were sold under those conditions it would be at declining values. The FDIC contends that in a well-run bank short-term maturing assets are assumed to be available to fund short-term volatile liabilities if the liabilities leave the bank. It is again stressed that most of Respondent's assets are funded by short-term liabilities.

Mr. Rullman disagrees with these contentions, and maintains that the same effect as having short-term assets

can be had by holding higher-yielding pledged securities which can be readily drawn upon. Tr. 648.

The FDIC's arguments on liquidity are a variation on its interest rate risk position. The effect that the futures position would have on the bank if interest rates increased is completely ignored, as previously stated.

Deference to the Opinions of Examiners

The FDIC asserts its position largely through the opinions of Examiner Poitevin. She is obviously a capable examiner with a good grasp of financial futures as they relate to banking, but she takes an extremely rigid and critical approach to the subject. If her views are adopted as general policy in this area, it would be very difficult for banking institutions to utilize futures in their operation, particularly one as small as Respondent. It is not believed that this approach reflects current policy.

Examiner Poitevin expressed a large number of criticisms of the practices of Respondent, concluding in each instance that the subject practice is unsafe and unsound, and could potentially have an abnormal risk or loss to the bank, to its shareholders, and to the Deposit Insurance Fund.

It is recognized that the logical possibility exists that these criticisms are valid, and the bank could nevertheless be in good shape, but the question does persist of how a bank so riddled with unsafe and unsound practices could achieve good earnings, and increase its capital, during an economic recession.

Respondent has filed a supplemental brief referencing the holding in the recently decided case, *Seidman v. Office of Thrift Supervision*, Nos. 92-3722/3729/5392, slip op. (3rd Cir. September 14, 1994) (1994 WL 498653).

The court there held that an unsafe and unsound practice is an imprudent act posing "an abnormal risk to the financial stability of the banking institution, and that, "a cease and desist order is designed to prevent actions that if repeated would carry a potential for serious loss."

Although it is evident that many of the acts and alleged acts that have been deemed unsafe and unsound by the FDIC examiners in this proceeding would not meet the tests laid down in the *Seidman* opinion, there are other grounds for declining to issue the cease and desist order being sought here.

Respondent's June 30, 1993 call report, made available shortly before the instant Notice was served on July 26, 1993, reports earnings on assets of 2.74 percent, earnings on equity of 35.1, and a Tier 1 capital ratio of 9.2 percent. Resp. Ex. 258.

The FDIC, *Citing Sunshine State Bank v. Federal Deposit Insurance Corporation.*, 783 F. 2d 1580 (11th Cir. 1986), contends that since in the opinions of its examiners, Respondent's activities in dispute here constituted unsafe and unsound banking practices, and that in their opinion the proposed cease and desist order is the appropriate remedy, it must be adopted unless their opinions are demonstrated to be unreasonable.

Although the *Sunshine* opinion establishes the deference that must be accorded to the opinions of examiners

in areas of their competence, it also recognizes that those opinions are not unreviewable, especially on factual matters which require no particular training or expertise.

The examiner opinions offered here are heavily mixed with factual claims, and as to those claims the opinions are quite contentious and selective.

It is proposed, generally, that a massive and onerous cease and desist order be imposed on Respondent because of the interest rate risk claimed to be reflected in its balance sheet. The justification offered to support the proposed order consists of GAP analyses of its assets and liabilities. Resolutely ignored is the risk-based capital position of Respondent.

Also determinedly ignored is the effect of the off-balance sheet futures position on Respondent's interest rate risk. The justification offered for this is that the position was not acquired in compliance with appropriately written policies and procedures. Even if this contention were true it would not nullify the financial effect of the futures.

It is claimed, as discussed, that Respondent has never identified the risk being hedged. However, the close correlation between treasury bill and Eurodollar interest rates and rates on bank deposits is conclusively shown, and not disputed. The converse movement of savings on Respondent's interest expense and costs of the futures is computed monthly, and is clearly demonstrated.

It is contended that there is no policy limitation on the amount of hedging contracts that may be used by Respondent. This claim is based on an asserted conflict

among different documents on the subject. Upon any reasonable interpretation of the documents there is no such conflict.

A GAP analysis prepared by a CPA reflecting the effect of the futures position on Respondent's interest rate risk is discounted on the grounds that the basis for the amount of futures included is not known, although that basis can readily be determined. Tr. 496-497, 666, 779-780.

Respondent is criticized for failing to determine the effects of the futures contracts on its general condition, but any consideration of the relation of the claimed hedge to its assets, capital, or taxes, is construed as proof that the risk being hedged has not been identified.

It is not believed that the holding of *Sunshine* can be applied as fully to the relatively undeveloped and uncharted policies in issue here as to those areas within the recognized expertise of examiners.

Proposed Order to Cease and Desist

The first paragraph of the proposed order would require Respondent to cease and desist from,

> engaging in hazardous securities investment and/or trading practices, including operating with excessive risk of loss due to interest rate fluctuations, resulting from, without limitation, the sale and/or acquisition of government securities, futures contracts, and mortgage derivative securities without adequate analysis and assessment of the interest rate risk involved and the effect of such activity on the Bank's earnings and capital;

This paragraph seems to rest on a number of assumptions that, as shown above, the weight of the evidence does not support. It apparently assumes, for instance, that Respondent is operating "with excessive risk of loss due to interest rate fluctuations." To reach this conclusion the effect of the claimed financial futures hedge and Respondent's risk based capital must be completed [sic] ignored.

It should be pointed out that the FDIC Examination Manual contains these directions for examiners:

> When futures are utilized for hedging purposes the effect of this activity should be reflected in the interest rate sensitivity analysis. For example, if the effect of a futures hedge is to lengthen liabilities, then the par value of the futures contracts should be subtracted from rate sensitive liabilities. Any adverse affect (sic) futures and forward contracts have on the interest rate risk of the institution should be noted in the comment sections of the interest rate sensitivity analysis. Any inappropriate speculative positions or positions which do not adhere to the institution's policy should be mentioned on the examiner comment and conclusion page.

FDIC Ex. 1-C, p. 5.2-10.

The futures position of Respondent was severely criticized following examinations, but the requirement stated in the first quoted sentence has not been complied with. The criticisms do not vitiate the economic effect of the futures. The only study in the record reflecting the impact of the futures position upon Respondent's interest rate risk shows the Bank's position to be moderately asset

sensitive, not excessively liability sensitive, as claimed by the FDIC. FDIC Ex. 30, p. 11.

Moreover, using the pending risk based capital standards, Respondent has been shown to be positioned to withstand its exposure to interest rate risk, with or without financial futures. Resp. Exs. 305 and 306.

This paragraph of the proposed order also assumes that the described securities investments were made "without adequate analysis and assessment of the risks involved." Tr. 582. Again, the evidence does not support this assumption. Long-term securities were purchased over a period of time pursuant to a deliberate strategy that included the expectation of an economic recession, possible loss on loans, erosion of collateral, high earnings on the securities, and the appreciation of value on previously purchased securities. Whatever flaws that were inherent in this strategy it has not been shown to have been through lack of analysis.

The same assumption is made about the futures transactions. It is not disputed that the initial contracts were sold before adequate board policies were in place. But to rely on that after extensive policies have been adopted as a result of examiner criticism and the execution of an MOU seems rather capricious, and it is not clear that this is being done. The critical argument is that no such policies were ever established.

The justification offered at the hearing for applying this paragraph to futures was that they were acquired "without adequate documentation to support that [they] are in compliance with the FDIC's policy statement and, therefore, are a hedge, as opposed to speculating." Tr.

582. The claim that adequate documentation does not exist to determine whether the futures are a hedge or speculation cannot be sustained.

Similar assumptions have been made about the REMIC. However, Mr. Rullman made a sufficient analysis of this transaction to determine that it was not a "high risk" investment. It is not completely clear what documentation was used for this analysis. As stated, it is impossible to believe, however, that the information used was confined to oral presentations of a broker. Even the cryptic data referred to by the examiners belie that.

Paragraph B of the proposed order would prohibit Respondent from operating with inadequate equity capital for the kind and quality of assets and off-balance sheet items held.

The stated bases for this requirement are that Respondent's capital was less that 6 percent as of December 31, 1991 (it was 6.8 percent as of March 31, 1992), that during the April 1992 examination is was determined that capital was below that required by the MOU, and that it has not been determined whether the futures constituted hedging or speculation, a subject previously discussed.

The MOU required Respondent to report monthly a hypothetically computed capital ratio reflective of an assumed three hundred basis point move on its futures positions, less 70 percent of the unrealized value of its securities. The examiners discovered during the examination that the method used by Respondent to compute the value of its securities was inadequate and that when the value was properly computed, the hypothetical capital

would be about 5.9 percent after a $6,000 reduction in the securities evaluation. Tr. 765.

Assuming a legal predicate exists for this capital requirement in the proposed order, it is not clear what purpose it would serve in view of Respondent's strong capital position, though obviously it would not be burdensome to comply with.

Paragraph C of the proposed order would prohibit Respondent from engaging in securities investment and/or trading practices which produce inadequate operating income.

The target of this requirement is not readily apparent from its language. At the hearing it was explained that the prohibition refers to losses incurred in futures transactions in late 1991. Tr. 583. As stated earlier, those losses amounted to over $300,000. Whether they can be justified would seem to depend upon whether the futures position was a hedge, which I have found to be well established. It is inconsistent with the concept of hedging to require that only income be received from that activity.

The following additional information should be considered in connection with the losses that Respondent has incurred on futures contracts. According to the unrefuted testimony of Mr. Rullman, he proposed at a meeting with FDIC officials in July 1991, where the possible use of futures to hedge Respondent's claimed interest rate risk was being discussed, that the Bank enter stop-loss orders on futures contracts which would only be executed after a certain sustainable increase in interest rates had occurred. This proposal was flatly rejected by the FDIC participants to the discussion with the comment that the risk must be

fully hedged now. Tr. 675. If Mr. Rullman's proposal had been accepted, the considered losses, resulting from a decline in interest rates, would not have occurred.

(It is recognized that a stop-loss order might fail to be executed immediately if the market moves too far in one day (50 basis points), though the likelihood of the market being repeatedly locked at this limit, and not trading over a sufficiently extended period of time to erode Respondent's financial position would seem quite remote. It is not known if any of this was the basis for the FDIC's position.)

The next two provisions of the proposed order would prohibit Respondent from,

> operating with management whose policies and practices are detrimental to the Bank or engaging in management policies and practices which are detrimental to the Bank; and failing to provide adequate supervision and direction over the affairs of the Bank to prevent unsafe or unsound practices.

The assumed target of these prohibitions is Mr. Rullman, though the Bank's board would also be covered. The sought prohibition is based on the contention that the Bank has been operating under hazardous management policies and practices.

In addition to the foregoing prohibitions, the proposed cease and desist order would also require Respondent to take an extensive list of affirmative actions. Among these required actions, would be to have and retain qualified management, including a chief executive

officer. The assessment of whether the Bank has "qualified management" would be determined by management's compliance with the proposed order, applicable laws and regulations, and "not engaging in any unsafe and unsound banking practice which has an adverse effect on the Bank's asset quality, capital adequacy, earnings, or liquidity."

Within 30 days from the effective date of the proposed order the board of directors would be required to develop a written analysis and assessment of the Bank's management and staffing, including an evaluation of each Bank officer, "in particular the chief executive officer."

The shareholders of the Bank, who are also members of the board, would be required to elect a majority of "independent board members." Independent is defined in such a manner to exclude all present members.

It would seem that these requirements are preliminary steps to the ouster of Mr. Rullman from the management of the Bank, as well as from any control by him through the board. His management has already been rated a "4" by the FDIC examiners, (he was rated a "3" by the State of Missouri) and his efforts at compliance with the outstanding MOU have been uniformly rebuffed, and were made the subject of this proceeding.

It is believed that there is an insufficient basis for these seemingly harsh and punitive measures on the record presented here, even assuming the validity of many of the criticisms directed at his management. Mr. Rullman, and his wife, are the virtual owners of the bank,

and as explained, he has successfully managed it into a fairly strong institution.

Moreover, it is difficult to imagine that other responsible individuals would now accept a position on Respondent's board at reasonable compensation in view of the regulatory fire the Bank is under. If the proposed cease and desist order is adopted the duties of the directors would be difficult, if not impossible to fulfill. Any failure to comply with that order would subject the directors to possible regulatory sanctions. The Bank does not carry director liability insurance.

The outstanding MOU already requires director-shareholders to make a concerted effort to obtain a majority of independent directors. These efforts were suspended because of threatened legal proceedings (the instant matter) and a reluctance to request individuals to assume a board position in the face of these difficulties. Tr. 796.

An outside CPA who was on the board resigned after a discussion with FDIC officials in which the possibility of imposing thousand-dollar-a-day money penalties on directors was mentioned. Tr. 795.

Paragraph 2 of the proposed cease and desist order refers to Funds Management. Although these proposed requirements were described by the FDIC as "extremely similar, if not identical, to . . . the requirements of the [MOU]," they are far more stringent and rigid. Tr. 589.

The MOU requires a "policy that establishes reasonable parameters, at all time horizons, for both the ratio of

rate sensitive assets to rate sensitive liabilities, and the ratio of rate sensitive liabilities to total assets."

Respondent adopted a policy stating, in relevant part,

> * * * The Bank's policy is to insure that adverse changes in interest rates of 200 basis points do not reduce average net income by more than 50%. To accomplish this objective, the three month gap will not exceed -40% of assets, and the one year gap will not exceed -40% of assets.

As the FDIC points out this policy does not include a ratio of assets to liabilities, and does not cover periods beyond one year. It also criticizes the absence of any limitation on asset sensitivity, though it has never been suggested that this was a problem with Respondent.

The proposed order requires "a range of acceptable" ratios for rate sensitive assets and liabilities for 90 days or less, 91 days through 100 days, 181 days through one year, more than one year and not more than three years, more than three years and not more than seven years, more than seven years and not more than 15 years, and more than 15 years.

Also required would be "guidelines" for offsetting a substantial portion of the Bank's volatile deposits and borrowings with liquid, short-term assets; for ratios of loans plus other long-term earning assets that may be funded by negotiable-rate certificates of deposits and borrowings; for conditions, and maximum amounts of borrowings, and specifications of officers authorized to

borrow; and contingency plans for meeting large unexpected withdrawals and a funds management committee would be required to be established.

Paragraph 2 also contains extensive record-keeping requirements.

Paragraph 3 incorporates the various outstanding requirements pertaining to futures transactions, and is reflective of the contentions made here, and considered above, that those requirements have been inadequately complied with.

The paragraph would further require the Bank to immediately dispose of all of its interest rate futures contracts if it fails (presumably as determined by the examiners) to comply with the requirements set forth in the paragraph.

Paragraph 3(a)(ii) would mandate that the Bank's futures policy require the Bank's board of directors to,

> identify the dollar amount of income, expense or value subject to interest rate risk to be offset, and the effect on the Bank's earnings under the seven market interest rate assumptions set forth in paragraph 5 of this ORDER;

The seven market interest rate assumptions in paragraph 5 are the following:

(i) no change in market interest rates;

(ii) an immediate and sustained increase in market interest rates of 100 basis points;

(iii) an immediate and sustained decrease in market interest rates of 100 basis points,

but in no event to market interest rate of less than 1 percent per annum;

(iv) an immediate and sustained increase in market interest rates of 200 basis points;

(v) an immediate and sustained decrease in market interest rates of 200 basis points, but in no event to a market interest rate of less than 1 percent per annum.

(vi) an immediate and sustained increase in market interest rates of 300 basis points, and

(vii) an immediate and sustained decrease in market interest rates of 300 basis points, but in no event to a market interest rate of less than 1 percent per annum.

Subparagraph (b)(iii) of Paragraph 3 states that the futures policy shall also require the Bank's board of directors to:

> [S]elect the appropriate interest rate futures contract (*e.g.*, Treasury Bills, Eurodollars, etc.), and establish and verify, on a monthly basis, the degree of correlation (which shall be between 80 and 120 percent) between the dollar amount of change in (A) the aggregate market value of the interest rate futures contracts, and (B) depending on the type of item or group of items for which the interest rate risk is to be reduced, the aggregate market value, the interest income, or expense associated with such item or group of items.

Paragraph 3(c) states:

> The Bank's board of directors shall support with appropriate documentation any actions to comply with the requirements of paragraphs 3(b) (i) through and including 3(b)(vi) of this ORDER which documentation shall be made a permanent part of the Bank's records and of the minutes of the board of directors. A copy of the documentation shall be provided to the Regional Director at the same time that the Bank submits the written progress reports required by paragraph 12 of this ORDER.

Paragraph 4 would require the Bank to perform a GAP analysis under two different methods. It is said to be necessary because "despite repeated requests, this bank has, to date, still not established an appropriate, consistent method of measuring interest rate risk." Tr. 591. As discussed, this claim ignores much of the evidence in this proceeding, including in particular, the risk capital analysis presented at the hearing.

Paragraph 5 of the proposed cease and desist order would require the Bank to prepare, quarterly, written detailed estimated income statements projecting income or loss over the next 24-month period, using each of the seven interest rate assumptions set forth above, as well as other assumed conditions.

This is described as "some income modeling that will give the FDIC a couple pieces of information," as well as being an analysis of the Bank's interest rate risk, and a demonstration of whether or not a hedge works under different interest rate scenarios. Tr. 592.

Proposed paragraph 6 requires that securities activity be conducted in strict compliance with the recommendations and requirements of the FDIC Statement of Policy entitled Supervisory Policy Statement on Securities Activities, 57 Fed. Reg. 4029 (1992).

The basis stated for this requirement is the contention that the single REMIC transaction discussed above was not made in compliance with that policy and without even having a prospectus.

Paragraph 7 of the proposed order refers to adequate allowance for loan and lease allowances. There is virtually no evidence in the record on this issue.

Proposed paragraph 8 requires the Bank to have and maintain Tier 1 capital at or in excess of 7 percent of the Bank's total assets.

There are other provisions of the proposed cease and desist order referring to the payment of dividends – the prior written consent of the Regional Director and the State Commissioner is required – and auditing procedures and reports to the Regional Director.

As the foregoing discussion shows, the proposed cease and desist order is extensive and complex. Although it includes exceedingly general terms, it imposes duties to refine in improbable detail matters that are inherently uncertain. It would obviously impose an onerous burden on a Bank as small as Respondent. It is difficult to view the provisions of the order as prescriptions to promote the financial health of Respondent. It would seem fair to conclude rather that the proposed order is designed for two primary purposes, first, to

remove Mr. Rullman from the Bank, and secondly, to rid the Bank of futures transactions.

It is doubtful that the Bank would be strengthened by these actions. Its financial structure has been designed and successfully managed by Mr. Rullman. The Bank is presently strong. It is not clear that it would remain so under altered circumstances. Indeed, the proposed radical restructuring of the Bank's financial position, and the removal of Mr. Rullman, could imperil the existence of the Bank. It would require the abrupt sale of solid high yielding appreciated securities, and the substitution therefor, of short-term business loans. It is doubtful that such loans of good quality could be instantly obtained.

As a possible alternative to using short-term liabilities to fund long-term assets, Respondent has considered joining the Federal Home Loan Bank. This would provide a source of long-term loans at reasonable rates. Peat Marwick was engaged to study the cost of such loans for Respondent. Resp. Ex. 241, p. 9. However, because of its regulatory problems Respondent does not qualify for membership in that system.

The use of "swaps" has also been considered by Respondent but they were rejected because it was found that they are less liquid than futures, and require more extensive bookkeeping. Tr. 904.

The proposed order would impose heavy and detailed responsibilities on the board of directors. It seems questionable if any board would be capable of carrying out these duties, and it is even more questionable whether a new board could be constituted for Respondent that would be capable of doing so.

Undoubtedly, Respondent would benefit from independent directors. It is recognized that one-man Banks, a category into which Respondent may, arguably, be placed, are not favored institutions. It seems fairly clear, however, that the recruitment and retention of independent directors would not be assisted by the imposition of the proposed cease and desist order.

It is concluded that any practices criticized in this proceeding that should be terminated may be eliminated by authoritative statements that do not include the imposition of the proposed cease and desist order upon Respondent. Although the distrust between Mr. Rullman and the FDIC representatives in this proceeding is complete, I believe any clear statement of prescription or proscription by the board would be followed by Respondent.

For the reasons stated, I recommend that the Board, in the exercise of its discretion, not impose the proposed order.

FINDINGS OF FACT

1. The Greene County Bank, Strafford, Missouri ("Bank") is and was at all times pertinent to this proceeding, a corporation existing and doing business under the laws of the State of Missouri as an insured State nonmember bank having its principal place of business in Strafford, Missouri. Respondent's Answer ¶ 1.

2. As of February 26, 1991:

(a) the Bank's total deposits equaled $18,230,000;

(b) the Bank's total loans equaled $9,388,000;

(c) the Bank's "Tier 1 or Core Capital" as defined in section 325.2(t) of the FDIC Rules and Regulations ("Rules"), 12 C.F.R. §325.2(t) ("Tier 1 capital"), equaled $1,427,000; and

(d) the Bank's "total assets" as defined in section 325.2(v) of the Rules, 12 C.F.R. §325.2(v) ("total assets"), equaled $18,860,000. Tr. 152-153; FDIC Ex. 3-a, pp. 7-8.

3. As of March 31, 1992:

(a) the Bank's total deposits equaled $17,974,000;

(b) the Bank's total loans equaled $8,477,000;

(c) the Bank's Tier 1 capital equaled $1,386,000; and

(d) the Bank's total assets equaled $20,371,000. Tr. 291-292; FDIC Ex. 16-a, pp. 18-19.

4. As of February 28, 1993:

(a) the Bank's total deposits equaled $17,058,000;

(b) the Bank's total loans equaled $7,195,000;

(c) the Bank's Tier 1 capital equaled $1,481,000; and

(d) the Bank's total assets equaled $19,046,000. Tr. 390-391; FDIC Ex. 21-a, p. 38.

5. At all times pertinent hereto, the Bank maintained capital in excess of the regulatory minimums (without including securities appreciation):

Date	Ratio
2/26/91	7.67
3/31/92	6.8
2/28/93	7.9

FDIC Exs. 3-a at p. 8, 16-a at p. 20, 21-a at p. 20.

6. The Bank experienced annual net income as follows:

Year	Amount
1985	126,000
1986	157,000
1987	203,000
1988	220,000
1989	200,000
1990	212,000
1991	24,000
1992	195,000

Resp. Ex. 288D at p. 11, FDIC Exs. 3-a at p. 9, 16-at p. 21, 21-a at p. 22.

7. The securities appreciation in the Bank's portfolio at various times pertinent hereto was:

Date	Amount
2/26/91	373,000
3/31/92	478,000
2/28/93	511,000

FDIC Exs. 3-a at p. 8, 16-a at p. 19, 21-a at p. 41.

8. The Bank's holding company is examined by the Federal Reserve. In its most recent examination concluded as of September 15, 1993, the holding company received a "2" rating. Resp. Ex. 259.

9. Funds management for a bank is an analysis of the volume of assets and the volume of liabilities and the timing of their maturity or repricing in relationship to each other. Interest rate risk is a component of funds management regarding the volume of assets and liabilities and the interest rate attached to those assets and liabilities FDIC (Exs. 2-a, 2-b and 2-c), as well as the timing of the maturity or repricing of those assets and liabilities to view the exposure of a bank's earnings and capital to future changes in interest rates. Tr. 56-58.

10. A certain amount of interest rate risk is inherent and appropriate in commercial banking. Resp. Ex. 285 at p. 48208; Tr. at 518.

11. The level of interest rate risk of any individual bank is difficult to measure precisely. Resp. Ex. 285 at p. 48208; Tr. at 518.

12. Interest rate risk has not been a principal threat to the financial health of commercial banks in the past. Resp. Ex. 285 at p. 48208; Tr. at 519.

13. "Maturity" refers to the time at which, under contract, the principal amount of a loan, for an example of an asset, or a certificate of deposit, for an example of a liability, becomes due and payable. Tr. 77. "Repricing" refers to the opportunity prior to maturity to change the interest rate on such an asset or liability, such as under an adjustable rate mortgage as an example where, under

contract, the interest rate is not fixed over the life of the contract but is adjustable at specified time periods, at which time the mortgage may be "repriced." Tr. 77.

14. To depict and analyze a bank's interest rate risk, the FDIC examiners utilize a "gap analysis model" ("GAP analysis") which is prepared by comparing the volume of assets and liabilities subject to interest rate adjustment by reason of maturity or repricing ("rate-sensitive assets" and "rate-sensitive liabilities," respectively) within specified time periods, usually of zero to three months ("3-month period"), zero to six months ("6-month period"), zero to twelve months ("12-month period"), and another time period if necessary to include in the analysis at least 75 percent of the rate-sensitive assets and rate-sensitive liabilities. Tr. 77-81; FDIC Ex. 2-d.

15. In preparing a GAP analysis, rate-sensitive assets are placed within the specified time periods based upon when the asset will mature or reprice or when the bank will receive the "cash flow principal" from those assets and likewise, rate-sensitive liabilities are placed within the time periods during which they mature or reprice. Tr. 78-79; FDIC Ex. 2-d, pp. 1-2.

16. Upon identifying the dollar volume of rate-sensitive assets and rate-sensitive liabilities maturing or subject to repricing at the designated time periods, a GAP analysis then compares the total volume of these assets and liabilities within each time period to find the dollar amount and the degree of any imbalance within each time period. Tr. 95-101; FDIC Ex. 2-d, p. 3.

17. The GAP analysis for each time period reviewed generally consists of three calculations and determinations:

(a) The "net position of assets," calculated by the total rate-sensitive assets for a given time period, less the total rate-sensitive liabilities in the same time period, for a net positive or negative amount as the case may be;

(b) the "net position of assets as a percentage of total assets," computed by taking the calculation above for a net position of assets in each time period and dividing it by the total assets of the bank, which provides the amount of what is commonly called "the GAP" for that time period; and

(c) "rate-sensitive assets as percentage of rate-sensitive liabilities," computed by dividing the total volume of assets by the total volume of liabilities for each time period. Tr. 96-101; FDIC Ex. 2-d, p. 3.

18. When the "net position of assets" is a negative amount in a given time period, which also results in a negative percent for the "net position of assets as a percentage of total assets" in that time period, the bank is "liability-sensitive" for that time period. Tr. 96-98. The interest rate risk of a liability-sensitive bank is that an increase in interest rates, because of the greater volume of repricing liabilities, will result in increased interest expenses without a similar increase in offsetting interest income, thereby lowering the bank's net interest income for the period at issue. Tr. 96-98; FDIC Ex. 2-d.

19. Generally, GAP analysis is used to analyze interest rate risk to short-term (12 months or less) earnings. Tr. 106.

20. The net dollar position of assets (liabilities) and the net position as a percent of total assets can be used to project estimated changes in net interest income based upon a change in interest rates. For instance, in a bank that is liability-sensitive in the 12-month period, the impact of an immediate and sustained one percent increase in interest rates over a 12-month period could be projected as follows:

(a) the net position of assets, being a negative amount for the 12-month period, multiplied by one percent, will equal the dollar amount of the projected negative impact on income for that period; and

(b) the net position of assets as a percent of total assets, being a negative percent for the 12-month period, multiplied by one percent, will equal the projected basis point (1/100 of 1%) decrease in the bank's percentage return on assets for that period. Tr. 103-106; FDIC Ex. 2-d, p. 4.

21. The calculation of rate-sensitive assets as a percentage of rate-sensitive liabilities is made to determine the amount of rate-sensitive assets that are offset by rate-sensitive liabilities in a given time period. Tr. 101. Examiners view as a generally accepted range or level for that percentage to be 80 to 120 percent, unless a bank has made further analysis that supports the safety of such a position. Tr. 101-102; FDIC Ex. 2-d.

22. In addition to GAP analysis, there are other generally accepted methods for measuring interest rate risk, such as duration and simulation models, which are more complicated and take into consideration more assumptions and, depending on the accuracy of the assumptions, could be more accurate than a GAP analysis. Tr. 109-141.

23. Duration analysis is the time weighted average of cash flows expressed in present value terms based on the rate-sensitive assets and rate-sensitive liabilities held by a bank. Tr. 109; FDIC Ex. 1-a, p. 5.2-2. Duration analysis requires very complex calculations and continuous updating of information because duration will change as interest rates change and as changes occur in time, *e.g.*, volume and nature of the items on the balance sheet. Tr. 110-111.

24. Pursuant to the FDIC Manual of Examination Policies, the FDIC will review a bank's duration analysis of interest rate risk if presented during an examination. Tr. 109-111; FDIC Ex. 1-a, p. 5.2-4.

25. A simulation model, generally, is a computerized model that will take a base of information from a bank's balance sheet and income statement, and then project changes resulting from different scenarios. Tr. 111-112. Such scenarios may include growth or decline in assets, growth or decline in deposits, impact of changes in interest rates on those items, and may include various levels of assumptions such as changes in interest rates within a 12-month period, the rate or speed at which such interest rates will change, and what effects those changes will have on the nature and composition of the balance

sheet and income statement. Tr. 111-140; FDIC Exs. 2-e through 2-h.

26. During the FDIC's examination of the Bank as of February 26, 1991, the GAP analysis performed by the FDIC reflected, as set forth in FDIC Ex. 3-a at page 10, the following:

(a) the Bank's total rate-sensitive assets formally maturing or otherwise formally subject to interest rate adjustment within time periods of six months, one year and five years were $1,983,000, $2,713,000 and $9,441,000, respectively;

(b) the Bank's total rate-sensitive liabilities maturing or otherwise subject to interest rate adjustment within time periods of six months, one year and five years were $15,315,000, $16,574,000 and $16,981,000, respectively;

(c) the Bank's net position of assets (liabilities), based on the above figures were for the six-month, one-year and five-year time periods was a negative $13,332,000, a negative $13,861,000 and a negative $7,540,000, respectively;

(d) the Bank's net position, based on the above figures, of assets as a percent of total assets in the six-month, one-year, and five-year time periods was a negative 67.11 percent, a negative 69.77 percent, and a negative 37.95 percent, respectively;

(e) the Bank's rate-sensitive assets as a percent of rate-sensitive liabilities in the six-month, one-year, and five-year time periods were

12.95 percent, 16.37 percent, and 55.60 percent, respectively, according to the figures used. Tr. 154-161.

27. Based on the Bank's interest rate risk thus computed as of February 26, 1991, and assuming net income for the next 12 months would otherwise equal the Bank's 1990 net income of $212,000 with a return on assets of 1.18 percent, the projected impact on that income from an immediate and sustained one percent increase in interest rates would be a decline of between $134,000 and $139,000, and a decline in the percentage return on assets of between 67 and 70 basis points, thereby reducing net income to between $73,000 and $78,000 and the return on assets percent to between 0.48 and 0.51 percent. Tr. 167-168; FDIC Ex. 3-e. This range of calculations was based upon whether the interest rate risk analysis includes assumptions for prepayment and amortization estimates for GNMA security pools owned by the Bank. Tr. 167-170, 333; FDIC Ex. 3-e.

28. As of February 26, 1991, the Bank's funds management policy did not address the management or monitoring of interest rate risk, even though the FDIC recommended such additions to that policy in its prior Report of Examination as of December 8, 1989. Tr. 179-180; Ex. 3-d, p. 14. The minutes from the meetings of the Bank's board of directors from January 1990 through February 1991 make no indication of any review and approval by that board of any interest rate risk analysis performed by the Bank. Ex. 31, pp. 126. As funds management and investment policy covering interest rate risk was adopted by the board on April 23, 1991. FDIC Exs. 15, p. 3 and 16-b-2.

29. During the FDIC's examination of the Bank as of April 3, 1992, the Bank's financial information used for that examination was as of March 31, 1992, and the GAP analysis performed by the FDIC reflected as set forth in FDIC Ex. 16-a at page 14, the following:

(a) The Bank's total rate-sensitive assets maturing or otherwise subject to interest rate adjustment within time periods of three months, six months, one year and three years were $1,892,000, $3,508,000, $5,964,000 and $12,800,000, respectively.

(b) the Bank's total rate-sensitive liabilities maturing or otherwise subject to interest rate adjustment within periods of three months, six months, one year and three years, were $9,692,000, $14,485,000, $15,902,000, and $16,255,000, respectively;

(c) the Bank's net position of assets (liabilities) in the three month, six month, one year and three year time periods was a negative $7,800,000, a negative $10,977,000, a negative $9,938,000, and a negative $3,455,000, respectively;

(d) the Bank's net position of assets as a percent of total assets in the three month, six month, one year and three year time periods was a negative 38.80 percent, a negative 54,60 percent, a negative 49.43 percent, and a negative 17.19 percent, respectively; and

(e) the Bank's rate-sensitive assets as a percent of rate-sensitive liabilities in the three month, six month, one year and three year

time periods were 19.52 percent, 24.22 percent, 37.50 percent, and 78.75 percent, respectively. Tr. 308-316.

30. By reason of the imbalance of the Bank's rate-sensitive assets to rate-sensitive liabilities as of March 31, 1992, excluding any consideration to off-balance sheet items, the Bank was heavily liability sensitive. Tr. 317.

31. Based on the Bank's interest rate risk, according to FDIC's GAP analysis, as of March 31, 1992, and assuming net income for the next 12 months would otherwise equal the Bank's 1991 net income of $24,000 with a return on assets of 0.12 percent, the projected impact on that income from an immediate and sustained one percent increase in interest rates would be a decline of between $99,000 and $119,000, and a decline in the percentage return on assets of between 49 and 59 basis points, thereby eliminating net income and causing a net loss of between $75,000 and $95,000, and a return on assets of between a negative 0.37 and a negative 0.47 percent. Tr. 318-325; FDIC Ex. 3-c. This range of calculations was based upon whether the interest rate risk analysis includes assumptions for prepayment and amortization assumptions for GNMA security pools owned by the Bank. Tr. 318-325, 333; Ex. 3-c.

32. During the examination of the Bank performed by the State of Missouri as of March 10, 1993, a GAP analysis was prepared based on financial information as of December 31, 1992, and reflected, as set forth in FDIC Ex. 21-a at page 44, the following:

(a) the Bank's total rate-sensitive assets maturing or otherwise subject to interest rate adjustment within time periods of three

months and twelve months were $1,195,000 and $3,606,000, respectively;

(b) the Bank's total rate-sensitive liabilities maturing or otherwise subject to interest rate adjustment within time periods of three months and twelve months were $9,609,000 and $13,539,000, respectively;

(c) the Bank's net position of assets (liabilities) in the three month and twelve month time periods was a negative $8,414,000 and a negative $9,933,000, respectively;

(d) the Bank's net position of assets as a percent of total assets in the three month and twelve month time periods was a negative 45.4 percent and a negative 53.6, respectively; and

(e) the Bank's rate-sensitive assets as a percent of rate-sensitive liabilities in the three month and twelve month time periods were 12 percent and 27 percent, respectively. Tr. 392-393.

33. The Bank was heavily liability sensitive, according to its balance sheet, as of December 31, 1992. Tr. 393-394.

34. Based on the Bank's interest rate risk as depicted in the state's report of examination, and assuming the net income for the next twelve months would otherwise equal the Bank's 1992 net income of $195,000 with a return on assets of 1.0 percent, the projected impact on that income from an immediate and sustained one percent increase in interest rates would be a decline of between $99,000 and $117,000, and a decline in the percentage return on assets of between 53 and 63 basis points, thereby reducing net income to between $78,000

and $96,000 and the return on assets percent to between 0.37 and 0.47 percent. Tr. 394-399; FDIC Ex. 22. This range of calculations was based upon whether the interest rate risk analysis includes assumptions for prepayments and amortization estimates for GNMA security pools owned by the Bank. Tr. 333, 394-399; FDIC Ex. 22.

35. The most recent FDIC examination, as of November 12, 1993, found that "the bank's liability sensitive [interest rate risk] position had improved since the previous [FDIC] examination." FDIC Ex. 28.

36. The FDIC examination as of November 12, 1993, also found that "the bank's capital had increased since the prior examination." FDIC Ex. 28.

37. A July 1, 1993 FDIC analysis of the Bank found that absent a "substantial change" in interest rates, the Bank "does not pose an immediate risk to the Bank Insurance Fund." Resp. Ex. 209.

38. The FDIC examination in 1992 found that the Bank "exceeds all of the risk based capital requirements" and that the Bank's "[r]isk-based capital ratio remains well above peer." FDIC Ex. 16-a at pp. 5, 20.

39. Section 305 of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires the federal banking agencies to revise existing risk-based capital standards to take adequate account of interest rate risk. The FDIC, the Federal Reserve Board and the Office of the Comptroller of the Currency initially sought comment on a possible framework for measuring interest rate risk in august 1992. In 1993, the three agencies, including

FDIC, promulgated new proposed standards for measuring interest rate risk, which would revise the risk-based capital standards to ensure that banks measure and monitor their interest rate risk and maintain adequate capital for the risk. Resp. Ex. 285; 58 Fed. Reg. 48206 (Sept. 14, 1993).

40. FDIC made no attempt to apply the new proposed standards for measuring interest rate risk in connection with its evaluation of the Bank's interest rate risk. Tr. at 840.

41. The new proposed standards for measuring interest rate risk address numerous issues not accounted for in a gap analysis such as that used by FDIC and provide a more accurate measure of interest rate risk. Tr. at 995-96; Resp. Ex. 285.

42. Application of the new proposed standards for measuring interest rate risk shows that the Bank's risk-based capital far exceeds regulatory minimums when adjusted for interest rate risk pursuant to the regulation. Tr. at 841-55; Resp. Exs. 305, 306.

43. The concept of liquidity is a bank's ability to sustain a decline in deposits and fund its assets in a profitable manner. Tr. 57.

44. Two aspects of a bank's liquidity analyzed by the FDIC are: first, a comparison of a bank's net cash, short term, and marketable assets to its net deposits and short term liabilities to calculate a quantitative measure known as the "liquidity ratio;" and second, an analysis of

the method of funding that liquidity to evaluate the stability or volatility of that funding. Tr. 172, 329-330; FDIC Exs. 3-a, p. 32; 16-a, p. 48; 21-a, p. 47.

45. In analyzing the methods of funding for liquidity, a comparison is made of short term investments in relationship to "volatile liabilities," which normally are either short term in nature or are generally viewed as deposits that will decline or increase by reason of a bank's pricing of those deposits in comparison to the market rates, and thus are not considered a stable base of funding. Tr. 172-173. The funds from such short term maturing investments are assumed to be available to fund the volatile liabilities should they fail to remain at the bank. Tr. 172-174. Thus, in the absence of sufficient short term investments, a bank would have to either attract replacement volatile liabilities, or obtain some other type of funding to replace the maturing volatile liabilities. Tr. 173-174. The significance of this analysis is that in the absence of sufficient short term investments, if interest rates increase, such funding through additional short term deposits or borrowings will be more costly. Tr. 174. Under such circumstances, if the bank chooses to obtain such funding by liquidating assets, it will have to sell long term, normally higher yielding assets, which under increasing interest rates will have declined in value. Tr. 174. Thus, under such circumstances and upon an increase in interest rates, the risk to the bank is that earnings will decline. Tr. 174-176.

46. In evaluating borrowing as a method of funding, there is an inherent difficulty in estimating a bank's ability to obtain funds in the market because until a bank actually attempts to borrow, it cannot determine with

confidence whether funds will be available at a price that will maintain a positive yield spread for the bank. FDIC Ex. 1-a, pp. 6.1-2, 6.1-3. Changes in money market conditions may cause rapid deterioration of a bank's capacity to borrow at a profitable rate. FDIC Ex. 1-a, pp. 6.1-2, 6.1-3; FDIC Ex. 16-a, p. 1-a-2.

47. As of February 26, 1991 the Bank's short term assets were 33.74 percent of the Bank's short term volatile liabilities; and

48. As of March 31, 1992 the Bank's short term assets were 5 percent of the Bank's short term volatile liabilities. The Bank's policy regarding any needs for liquidity was to rely on funding such needs through borrowings or sale of liquid assets.

49. As of February 28, 1993:

(a) the Bank's short term assets were 1.64 percent of the Bank's short term volatile liabilities;

(b) the Bank was frequently relying on borrowings or the sale of assets to fund its liquidity needs; and

50. The Bank's liquidity position is bolstered by the ready availability of its appreciated securities and the stability of its deposit base, and the Bank is well prepared to meet any liquidity needs. The Bank's liquidity position does not present any abnormal risk or reasonably direct effect on the Bank's financial soundness. Tr. at 641-48, 658-59; Resp. Exs. 297, 298.

51. A futures contract is an agreement between two parties, a buyer (characterized as a "long position") and a

seller (characterized as a "short position"), for the sale of a specified commodity (in this case being interest rate-sensitive securities) at a specified date. Tr. 144-145; FDIC Ex. 6-a. Upon arrival of the specified date, or prior to that time, a party to a futures contract will generally "close their position," in that the individual will not actually deliver or receive the security, but instead will take a position in an "offsetting contract." Tr. 145-148. An "offsetting contract" would be a contract for the same security and sale date as the original contract, but under which the party would take the opposite position (buyer or seller) from that held in the original contract. Tr. 145-148. A gain or loss would be recognized on the difference of the price in the original contract and the price in the offsetting contract. Tr. 145-148; FDIC Ex. 6-a.

52. A "hedge" transaction is a transaction used to offset a market risk in one transaction by assuming a market risk of the opposite nature in a separate transaction. Tr. 211-222; FDIC Exs. 6-a; 6-d. These opposing financial positions protect against unfavorable market movements, thereby reducing the overall risk of loss with respect to the item being hedged. Tr. 211-222; FDIC Exs. 6-a; 6-d.

53. The Bank has executed a strategy of hedging its liability portfolio with financial futures to control interest rate risk. This strategy was initiated at a time when there was a previous FDIC Notice of Charges, concerning interest rate risk, pending against the Bank. That Notice of Charges was dismissed after the parties entered into the MOU. Tr. at 677, 694-95.

54. Hedging with financial futures is a valid and proven method for controlling interest rate risk. Tr. at 186, 517, 518, 969-70; FDIC Ex. 21-a at p. 58.

55. The Bank's initial efforts concerning the financial futures market and hedging were authorized at board of directors meetings held on April 23, 1991, and June 27, 1991. At the latter meeting, the board resolved to enter into contractual relationships with certain brokerage firms. FDIC Ex. 31; Tr. at 671.

56. The Bank executed a confirmation to its brokerage firm that its purchase of futures contracts was for the purpose of hedging. GCB Ex. 266; Tr. at 671.

57. In September 1991, the Bank entered into approximately 80 futures contracts with maturities of March 1992, which obligated the Bank to sell in the future $80,000,000 of U.S. Treasury Bills and Eurodollar securities, as well as an option contract in which the Bank was obligated to honor an option to sell to a buyer specified futures contracts at a price fixed as of September 10, 1991, if the option was exercised prior to November 16, 1991. Respondent's Answer ¶ 7. The first acquisition of futures contracts was the acquisition of 20 contracts of September 9, 1991. FDIC Ex. 10-b, p. 6. The subsequent acquisitions occurred on September 13, 1991 (20 futures contracts and the option contract), September 24, 1991 (20 contracts), and September 26, 1991 (20 contracts). FDIC Ex. 10-b, p. 6.

58. The futures contracts covered by the option contract had to have a maturity of December 31, 1991, with the underlying securities being U.S. Treasury Bonds of $1,000,000 par value. Respondent's Answer, ¶ 7; FDIC Ex.

10-b. The option contract was a "naked call option" in that the Bank was obligated to honor an option to sell certain futures contracts on or before November 16, 1991, to a buyer at a certain price fixed as of September 13, 1991, when in fact the Bank did not own the subject futures contracts, nor the underlying U.S. Treasury Bonds. Tr. 226, 941-942. Accordingly, if the holder of the option exercised it in accordance with its terms, the Bank would have to purchase the subject futures contracts at the then current market price and sell them to the option holder at the price fixed as of the date of the option. Respondent's Answer, ¶ 7; Tr. 232-233.

59. With respect to the acquisition of futures contracts, the Bank made its first acquisition on September 9, 1991, by entering into 20 contracts. Tr. 243-244; FDIC Ex. 10-b, p. 6. However, the Bank's board of directors did not discuss the Bank's actual acquisition of those futures contracts until its meeting of September 10, 1991. Tr. 242-244, 938-939; FDIC Exs. 7, p. 1; 31, p. 40.

60. At a September 10, 1991 board of directors meeting, President Rullman presented information to the board on hedging with financial futures. In particular, he guided the directors through the process of acquiring futures using *The Wall Street Journal* and other information. FDIC Exs. 31, 31-b; Resp. Ex. 232; Tr. at 679-82, 685-86.

61. The Bank commissioned a study of interest rate futures correlation by the firm of KPMG Peat Marwick. The firm's report was completed in December 1991 and was made available to FDIC. Resp. Ex. 241; Tr. at 342-43, 521, 522-523, 537, 544, 707.

62. FDIC concluded that the KPMG Peat Marwick study "did show correlation between the institution's liabilities and stated values for futures contracts." Resp. Ex. 214; Tr. at 522-23.

63. A report by the IBAA Securities Corporation, which reviewed the Bank's portfolio, showed a significant reduction in the Bank's interest rate risk under an FDIC-like GAP analysis after the hedge was properly taken into account. Tr. at 777-81; FDIC Ex. 30.

64. As determined in the FDIC's examination of the Bank as of April 3, 1992, the Bank had entered into and was holding 80 futures contracts which obligated the Bank to sell in the future $80,000,000 of U.S. Treasury Bills with maturities ranging from June 1992 to September 1992, and which were different contracts from those acquired previously in September 1991. Respondent's Answer ¶ 8; Tr. 335-336; FDIC Exs. 16-a, p. 23; 16-b-6.

65. (a) As determined in the State's examination of the Bank as of March 10, 1993, the Bank had entered into and was holding 120 futures contracts:

(i) 60 of which by their terms obligated the Bank to make future sales (short) of U.S. Treasury Bills in a par amount of $60,000,000, with contract maturities of June 1993;

(ii) 40 of which by their terms obligated the Bank to make future sales (short) of Eurodollar securities in a par amount of $40,000,000 – 20 with contract maturities of March, 1993, and 20 with contract maturities of June 1993; and

(iii) 20 of which by their terms obligated the Bank to make future purchases (long) of Eurodollar securities in a par amount $20,000,000, with contract maturities of December 1993. Respondent's Answer ¶ 8; Tr. 403-404; FDIC Ex. 21-a, p. 38.

(b) On March 24, 1993, the Bank replaced some of its contracts with new contracts with different maturities and entered into 40 additional futures contracts, 20 of which by their terms obligated the Bank to make future sales (short) of Eurodollar securities in a par amount of $20,000,000, and 20 of which by their terms obligated the Bank to make future purchases (long) of Eurodollar securities in a par amount of $20,000,000, for a total of 160 futures contracts in a par amount of $160,000,000, with 120 short contracts having contract maturities ranging from June to December 1993, and 40 long contracts having contract maturities ranging from June to September 1994. Respondent's Answer, ¶ 8; Tr. 403-404; FDIC Ex. 21-a, p. 58;

(c) As of October 27, 1993, the Bank had entered into an [sic] was holding 240 futures contracts:

(i) 100 of which by their terms obligated the Bank to make future sales (short) of Eurodollar securities in a par amount of $100,000,000, with contract maturities of March 1994.

(ii) 60 of which by their terms obligated the Bank to make future sales (short) of U.S. Treasury Bills in a par amount of

$60,000,000, with contract maturities of March 1994; and

(iii) 80 of which by their terms obligated the Bank to make future purchases (long) of Eurodollar securities in a par amount of $80,000,000, with contract maturities of December 1993 for 40 contracts, June 1994 for 20 contracts, and September 1994 for 20 contracts. Tr. 430-432; FDIC Ex. 27.

66. A July 23, 1992 FDIC analysis of the Bank found that "it appears that Chairman Rullman's hedge theoretically offsets a liability sensitive [interest rate risk] position," and that absent a substantial change in interest rates the Bank did not pose an immediate risk. Resp. Ex. 218.

67. The Bank's basic hedging program has been confined to the use of short-term financial instruments to hedge short-term liabilities. This type of hedging entails comparably little risk when contrasted with other potential hedging strategies. Tr. at 976-81; Resp. Ex. 308.

68. As indicated above, the Bank first entered into futures contracts in September 1991. The Bank's net income year-to-date as of September 30, 1991, was $254,000. Tr. 370; FDIC Ex. 11, p. 2. As of December 31, 1991, the Bank's 1991 net income was reduced by more than $225,000 to $24,000, with a reduced return on assets of only .12 percent. Tr. 370; FDIC Ex. 12. This reduction in earnings in 1991 was due to a loss of $301,000 suffered by the Bank on its futures contracts. Tr. 371; FDIC Ex. 16-a, pp. 3, 21-23.

69. As of April 3, 1992, the Bank was experiencing a $72,000 gain on its year-to-date position in futures contracts. Tr. 371. However, by year-end 1992, the Bank lost that gain plus $164,000. Tr. 412; FDIC Ex. 21-a, p. 23. That nine month loss of $236,000 on futures contracts reduced the Bank's year-end net income and return on average assets to $195,000 and one percent, respectively. FDIC Ex. 21-a, p. 22.

70. For the first two months of 1993, the Bank lost $55,000 on its futures contracts. Tr. 412-413; FDIC Ex. 21-a, p. 23.

71. The Bank's net losses on futures contracts during the approximately 18 month period of September 1991 through February 28, 1993, equaled $520,000, an amount more than one-third of the Bank's Tier 1 capital as of February 28, 1993. Tr. 412, 390-391, FDIC Ex. 21-a, pp. 23, 38.

72. The Bank's basic hedging program using short positions in financial futures has been effective in controlling the Bank's interest rate risk. Gains and losses in the Bank's liability portfolio have been offset by the corresponding gains and losses incurred in the short positions in financial futures contracts. Tr. at 631-32, 699-703; Resp. Exs. 218, 272, 273; Tr. at 971-73; Resp. Ex. 307. As the strategy has been executed by the Bank, it has presented no abnormal risk of loss to the Bank. Tr. at 981, 1008.

73. When considered in context with the Bank's capital position and appreciated securities portfolio, the Bank's strategy could not reasonably have adversely affected on the Bank's financial soundness. This point is

illustrated by the FDIC's April 3, 1992 report of examination, at page 4-1-a. FDIC Ex. 16-a at p. 23. Under the FDIC's analysis, it appears that were interest rates to fall to zero the Bank's futures losses would be less than the appreciation in its securities portfolio. Conversely, if interest rates were to increase, the Bank would realize gains from the futures. Tr. at 465-67, 996-1000.

74. In connection with its supervision of the Bank, the State consulted with several banks who advised that "the viability of bank was not threatened in a worst case scenario." Resp. Ex. 277. The State concluded that "foreseeable losses would largely be offset with securities gains [with] no substantial impact to capital" and that it "could not show the bank has been actually harmed." *Id.*

75. Among the FDIC's criticisms of the Bank was the cost of the Bank's hedging program. FDIC Ex. 16-a at p. 26. Beginning in late 1992 and pursuant to a written strategy, Tr. at 799, FDIC Ex. 21-b-5, the Bank acquired long positions in financial futures as an investment strategy designed to reduce the expense of the basic hedging program in the then-current rate environment. Tr. at 801-02. The long positions have effectively reduced the expenses of the Bank's basic hedging program, and they do not present any abnormal risk or reasonably direct effect on the Bank's financial soundness. Tr. at 801-02, 1019. The positions were consistent with the Bank's policy, Tr. at 803, and were reviewed by the board's ALCO Committee. Tr. at 804-05, FDIC Ex. 32 (minutes from February 26 and March 29, 1993).

76. As reflected above, the Bank's net annual income for 1991 dipped to $24,000. In the previous year,

1990, it had been $212,000 and in the subsequent year, 1992, it was $195,000. *Supra* ¶ 3. The dip in 1991 year-end earnings is not, however, reflective of any practice or condition at the Bank that presented abnormal risk or a reasonably direct effect on its financial soundness. The Bank's basis hedging program had been instituted in the fourth quarter of 1991. As a consequence, the Bank was required to book futures losses at year-end, before it realized the offsetting gains from the repricing of its liabilities in the following year. Viewed without reference to year-end accounting conventions, the Bank's earnings were relatively stable during the time periods at issue here. Tr. at 613-15, 974-76.

77. The Bank entered into a Memorandum of Understanding ("MOU") with the FDIC on February 14, 1992. Paragraph 11(a) of the MOU required the Bank to maintain Tier 1 capital of six (6) percent of average total assets. FDIC Ex. 13.

78. In response to the requirements of the MOU, the Bank submitted voluminous materials to FDIC. In its initial "MOU response" on March 11, 1992, the Bank submitted an Asset/Liability Management Policy Statement, and Interest Rate Strategy, a Funds-Management and Investment Policy, draft Asset and Liability Committee minutes, and supporting information. These submissions fulfilled in all material respects the bank's obligations under paragraphs 1(a), 1(b), 1(c), and 9(a)(i) of the MOU. FDIC Ex. 15; Tr. at 739-51.

79. The Bank's Asset/Liability Management Policy Statement submitted to the FDIC on March 11, 1992, had

previously been provided to the FDIC in draft form without adverse comment. FDIC Ex. 15; Resp. Ex. 233; Tr. at 711-12.

80. After its initial submission, the Bank provided regular reports to the FDIC pursuant to the MOU and regarding the Bank's position generally, including the following:

Resp. Ex. 216	–	4/15/92 letter from GCB to FDIC with actions taken to comply with MOU
Resp. Ex. 217	–	5/15/92 letter from GCB to FDIC with MOU report
Resp. Ex. 219	–	7/14/92 letter from GCB to FDIC with MOU report
Resp. Ex. 221	–	8/8 92 letter from GCB to FDIC with MOU report
Resp. Ex. 222	–	8/14/92 letter from GCB to FDIC regarding overall condition of bank
Resp. Ex. 224	–	9/4/92 letter from GCB to FDIC with MOU report
Resp. Ex. 225	–	10/9/92 letter from GCB to FDIC with MOU report
Resp. Ex. 226	–	12/7/92 letter from GCB to FDIC with MOU report
Resp. Ex. 201	–	1/7/93 letter from GCB to FDIC with MOU report
Resp. Ex. 202	–	2/1/93 letter from GCB to FDIC with MOU report
Resp. Ex. 203	–	3/4/93 letter from GCB to FDIC with MOU report

Resp. Ex. 204	–	3/8/93 letter from GCB to FDIC with corrected MOU report
Resp. Ex. 205	–	4/9/93 letter from GCB to FDIC with MOU report
Resp. Ex. 207	–	5/13/93 letter from GCB to FDIC with MOU report
Resp. Ex. 23	–	5/11/93 letter from GCB to FDIC with ALCO minutes
Resp. Ex. 208	–	6/1/93 letter from GCB to FDIC with MOU report
Resp. Ex. 211 and Ex. 257	–	7/9/93 letter from GCB to FDIC with MOU report
Resp. Ex. 258	–	8/2/93 letter from GCB to FDIC regarding overall condition of bank

See also Tr. at 739-51, 766-75, 781-84, 794, 797-98, 806-07, 811-12, 814. These submissions show that, consistent with paragraph 11 of the MOU, the Bank at all times maintained adequate capital at the levels and pursuant to the calculations and adjustments required by the MOU.

81. The MOU required the Bank to submit its policies to FDIC for "review and comment, and required a response from the FDIC Regional Director. The FDIC never specifically responded to the policies submitted by the Bank. Tr. at 750-51; GCB Ex. 206.

82. In February 1992, the Bank purchased as an investment a Federal National Mortgage Real Estate Mortgage Investment Conduit ("FNMA REMIC") in the amount of $150,000. Tr. at 721. Prior to acquiring the

FNMA REMIC, an analysis of the security was performed by President Rullman, Tr. at 722-23; Resp. Ex. 239 at p. S-38, who concluded within his authority and ability that the FNMA REMIC was not a "high risk security" under FDIC guidelines. Tr. at 222-24; *see also* Tr. at 1002. Such securities are not supposed to be sold without the prior delivery of a prospectus, Tr. at 100, and the instrument here passed the applicable regulatory test. FDIC Ex. 30 at p. 65; Tr. at 728. The FNMA REMIC paid off within one year and resulted in no loss to the Bank. Tr. at 725. It was intended to be a liquid, short-term, high-yield investment for the Bank, and it performed as anticipated. Tr. at 724-25. The acquisition of the FNMA REMIC did not present an abnormal risk to the Bank and had no reasonably direct effect on the Bank's financial soundness.

83. All statements of fact in the above Discussion of Facts and Law are incorporated herein by reference.

CONCLUSIONS OF LAW

1. The Respondent is and was, at all times pertinent to this proceeding, an insured state nonmember bank subject to the Federal Deposit Insurance Act ("Act"), 12 U.S.C. §§ 1811-1831t, and the FDIC's Rules and Regulations, 12 C.F.R. Chapter III.

2. The FDIC has jurisdiction over the Bank, the Bank's "institution-affiliated parties" as that term is defined in section 3(u) of the Act, 12 U.S.C. § 1813(u), and the subject matter of this proceeding.

3. The FDIC has the authority to issue an order to cease and desist against the Bank pursuant to section 8(b) of the Act, 12 U.S.C. § 1818(b).

4. The FDIC's burden of proof in this proceeding is one of a preponderance of the evidence. *In the Matter of the American Bank of the South, Merritt Island, Florida,* FDIC-92-17b, 1 FDIC Enforcement Decisions and Orders ¶ 5195 at A-2233 (March 30, 1993), citing *Steadman v. Securities and Exchange Commission,* 450 U.S. 91, 102 (1981).

5. The opinions and conclusions of FDIC examiners concerning the quality and efficacy of bank operating policies and the risks associated with specific bank practices are entitled to great weight unless the opinions and conclusions are shown to be arbitrary or capricious or outside a zone of reasonableness. These opinions, however, are not unreviewable, especially on factual matters, not requiring the exercise of examiner expertise. *In the Matter of the American Bank of the South, Merritt Island, Florida,* FDIC-92-17b, 1 FDIC Enforcement Decisions and Orders ¶ 5195 at A2234 (March 30, 1993); *see also, Sunshine State Bank v. Federal Deposit Insurance Corporation,* 783 F.2d 1580 (11th Cir. 1986).

6. Respondent is not operating in an unsafe and unsound condition because of its futures contracts.

7. The Bank's sale of call options was, according to the Examination manual, an unsafe and unsound practice.

8. The Bank has complied with the MOU in material respects but it has not adopted an investment policy in full compliance with paragraph 1(c) of that agreement.

9. The Bank's acquisition of FNMA REMIC was not an unsafe and unsound practice.

10. The Bank's investment and trading practices as alleged in the Notice of Charges are not unsafe and unsound practices.

11. The Bank has not engaged in any unsafe and unsound practices that would warrant the issuance of an order to cease and desist pursuant to Section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b).

So Ordered this 31st day of October, 1994.

/s/ Arthur L. Shipe
Arthur L. Shipe
Administrative Law Judge

PROPOSED ORDER

Upon consideration of the record as a whole, it is hereby

ORDERED that the Notice of Charges is dismissed and, accordingly, the request for issuance of an order to cease and desist is **denied.**

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, DC

In the Matter of THE GREENE COUNTY BANK STRAFFORD, MISSOURI (INSURED STATE NONMEMBER BANK)	**CERTIFICATE OF SERVICE** FDIC 93-160b

I am Gerald J. Langan, Law Clerk to Administrative Law Judge Arthur L. Shipe, Office of Financial Institution Adjudication, Washington, DC.

The complete Record of the above-captioned proceeding consists of the following described documents, which are filed in reverse chronological order, as set forth below:

Filed Volumes 1 & 2, containing the Recommended Decision, and Post-Hearing filings.

4 Transcripts of Proceeding, with 3 volumes of FDIC Hearing Exhibits and 3 volumes of Respondent's Hearing Exhibits.

Filed Volume 3, containing the Pre-Hearing filings.

On October 31, 1994, I caused to be served upon the following parties, the matters described below.

By Hand Delivery, a complete copy of the original Record of this proceeding upon:

Mr. Robert E. Feldman
Deputy Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, DC 20429

By Hand Delivery, a copy of the Recommended Decision upon:

Mr. Arthur L. Beamon
Associate General Counsel
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, DC 20429

By Federal Express Delivery, a copy or the Recommended Decision upon:

Mr. Gerald F. Lamberti, Esq.
Regional Counsel, FDIC
2345 Grand Avenue, Suite 1500
Kansas City, Missouri 64108

And by the same method, a copy of the Recommended Decision upon:

Ms. Lynn R. Dadisman, Esq.
Mr. John J. Oldenburg, Esq.
Federal Deposit Insurance Corporation
2345 Grand Avenue, Suite 1500
Kansas City, Missouri 64108

Mr. Charles W. German, Esq.
Mr. Brant M. Laue, Esq.
Rouse, Hendricks, German, May & Shank, P.C.
One Petticoat Lane Building
1010 Walnut, Suite 400
Kansas City, Missouri 64106

Dated this 31st day of October, 1994, at Washington, DC.

/s/ Gerald J. Langan
Gerald J. Langan
Law Clerk to Judge
Arthur L. Shipe
Administrative Law Judge

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C.

In the Matter of THE GREENE COUNTY BANK STRAFFORD, MISSOURI (Insured State Nonmember Bank)	FDIC-93-160b DECISION AND ORDER

STATEMENT OF THE CASE

1. Introduction

This matter is before the Board of Directors ("Board") of the Federal Deposit Insurance Corporation ("FDIC") for review of the Recommended Decision of Administrative Law Judge Arthur L. Shipe ("ALJ") dated October 31, 1994.[1] The ALJ recommended that no cease and desist order issue against The Greene County Bank, Strafford, Missouri ("Bank"), and FDIC Enforcement Counsel filed Exceptions. After submission of the case to the Board, the FDIC's Acting Executive Secretary, pursuant to delegated authority, under the advice and recommendation of the General Counsel, issued an order reopening and seeking supplementation of the record. Additional information was submitted by the Bank on May 1, 1995.

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[1] Citations to the Recommended Decision shall be "R.D. at ___." "Ex." citations are to the Exhibits admitted into evidence by the ALJ. "Tr." references are to the testimony at the hearing before the ALJ.

This case involves the propriety of certain futures transactions in which the Bank engaged. Such transactions, which can be an effective tool for controlling interest rate risk, can also present significant risks if a financial institution does not exercise a great deal of care. Frequently, these transactions can raise critical issues concerning suitability, prior approval, recordkeeping, and separation of functions for financial institutions involved in them. This case is the first one to come before the Board involving the use of futures to hedge interest rate risk, and the FDIC has not recently issued guidance on this subject.

As set forth below, the Board agrees with many of the ALJ's factual findings. However, the Board is troubled by some of his discussion of the issues and his ultimate decision not to issue a cease and desist order, even one less onerous than the 25-page proposed order submitted by FDIC Enforcement Counsel, in light of his findings of fact. After a full, independent review of this record in its entirety, the Board concludes that a cease and desist order should issue and reverses the ALJ's decision. However, the Board declines to adopt the order proposed by FDIC Enforcement Counsel in favor of a more modest order that properly recognizes both the progress the Bank has made in dealing with interest rate risk and the validity of some of FDIC Enforcement Counsel's criticisms of the Bank's conduct.

2. Procedural Background

The case arises out of the issuance of a Notice of Charges and of Hearing dated July 26, 1993 ("Notice") to

initiate a proceeding for the purpose of determining whether an order should be entered against the Bank pursuant to section 8(b) of the Federal Deposit Insurance Act ("FDI Act"), 12 U.S.C. § 1818(b). The Notice was based on alleged unsafe and unsound practices arising out of the Bank's transactions in financial futures and its liquidity position.

The Bank contested the Notice, and a hearing took place before the ALJ on January 24-27, 1994. After post-hearing briefs were filed, the ALJ issued his Recommended Decision declining to issue a cease and desist order on October 31, 1994.

Thereafter, FDIC Enforcement Counsel filed Exceptions to the Recommended Decision. On March 21, 1995, the FDIC's Acting Executive Secretary, pursuant to delegated authority, under the advice and recommendation of the General Counsel, issued an order reopening the record so that the parties could submit additional information on three issues identified in the order. The Bank submitted a Supplemental Brief dated May 1, 1995. FDIC Enforcement Counsel has filed objections to the order and the Bank's Supplemental Brief but has not otherwise responded to the order.[2]

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[2] This Board fails to understand the basis of FDIC Enforcement Counsel's.objection. Certainly FDIC Enforcement Counsel cannot be suggesting that this Board lacks the authority to seek information which it deems necessary for it to reach a fully informed decision on the merits in this proceeding.

3. Pertinent Facts

a. The Bank and its interest rate risk problem

The Bank is small and, in recent years, has had less than $20 million in assets. R.D. at 3. At the time of the hearing, assets totalled $16.5 million. *Id.* A substantial portion of the assets consists of long-term securities. R.D. at 5. The Bank has maintained stable earnings and adequate capital at all pertinent times. R.D. at 73-74, 101, 103.

The Bank is essentially a one-person operation run by its president, Bernard H. Rullman, Jr. R.D. at 3. He and his wife own the holding company that owns the Bank. *Id.* Mr. Rullman is clearly a knowledgeable individual and successful banker, but, as the ALJ noted, "he seems to listen to his own drummer in banking matters." *Id.* As a result, he has had difficulty in carrying out the Bank's obligations under applicable FDIC policies and the Memorandum of Understanding ("MOU") entered into with the FDIC and the State of Missouri regarding, *inter alia*, the Bank's investments in futures contracts as a way to reduce interest rate risk.

Some interest rate risk is inherent in commercial banking. R.D. at 75. Historically, the Bank has had significant and above normal balance sheet exposure to interest rate risk, as noted by the FDIC's Report of Examination dated December 8, 1989, and all of the subsequent examinations, although its position has improved. R.D. at 82-83, 84, 86, 87. Its balance sheet is highly "liability sensitive" in that an increase in interest rates will cause it to have increased interest expenses without a corresponding increase in interest income and thereby lower the net interest income for the period. R.D. at 78.

This interest rate risk presents a threat to the Bank if not properly addressed. One of the methods of reducing the risk is to engage in "hedging" with financial futures contracts. R.D. at 92. A hedge transaction involves offsetting a risk in one market – in this case the risk that an increase in interest rates will increase the cost of the Bank's liabilities – by taking on the opposite risk in the futures market. *See id.*[3] If the hedge is constructed properly, increased costs of the Bank's liabilities will be offset by gains in the futures transactions. *See* R.D. at 33. Conversely, a lowering of the costs of the Bank's liabilities will be offset by losses on the futures. The primary issue in this case is the manner in which the Bank has confronted its interest rate risk by using such futures.

b. The Bank's initial effort to address interest rate risk

Prior to the February 26, 1991 examination, the Bank had made no attempt to address interest rate risk despite the FDIC's recommendations to do so. R.D. at 82-83. However, on April 23, 1991, the Bank adopted a Funds Management & Investment Policy ("Policy") dealing with interest rate risk. R.D. at 83. The Policy did little more than generally authorize the Bank to invest in futures, limited those investments to an amount equal to total loans and investments, and delegated implementation to the Asset/Liability Committee ("ALCO"). Ex. 16-b-2. On June 27, 1991, the Bank's Board of directors ("Board")

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[3] The ALJ's Recommended Decision contains a very good discussion of hedging using futures. R.D. at 91-92.

authorized the Bank to enter into futures contracts with brokerage firms for the purpose of hedging. R.D. at 93; Ex. 266.

In September 1991, the Bank acquired 80 short futures contracts. R.D. at 93. The acquisition of the first 20 contracts occurred on September 9, 1991, prior to any discussion by the Bank's board. R.D. at 94. On September 10, 1991, the Bank's board did discuss the mechanics of hedging using financial futures and the acquisition of further contracts. R.D. at 94-95. Thereafter, the Bank acquired the other 60 contracts. R.D. at 93. In addition, the Bank sold a "naked call option." R.D. at 93-94.[4] Beginning September 1991, the Bank acquired more and more futures contracts and, as of October 27, 1993, held 240 contracts of which 160 were short and 80 were long. R.D. at 96-98.

c. The Memorandum of Understanding

On August 9, 1991, prior to the acquisition of the first futures contracts, the FDIC had brought proceedings against the Bank under section 8(b) of the FDI Act because of the unaddressed interest rate risk exposure. R.D. at 6. In settlement of that proceeding, on February 14, 1992, the Bank executed the MOU, and that document is at the heart of this case. R.D. at 8. The most relevant

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[4] There is no question that this investment was speculative and not part of the hedging program. R.D. at 45-46. It exposed the Bank to the possibility of substantial losses; fortunately, however, the Bank incurred no loss, and never engaged subsequently in any similar transactions. *Id.* at 46.

portions are set forth verbatim in the Recommended Decision at pages 8-9. Essentially, the MOU required the Bank to develop a detailed written plan for dealing with interest rate risk exposure and a detailed written policy governing the use of futures to reduce interest rate risk. R.D. at 8. Among other things, the MOU mandated:

> (1) specific identification of the assets or liabilities to be hedged including the amount and desired maturity of the hedge;
>
> (2) selection of appropriate futures contracts based on a correlation analysis and continued analysis and verification of the correlation on a monthly basis;
>
> (3) identification of the exposure to be hedged, i.e., the "gap";[5]
>
> (4) determination of the effective cost of the hedge and whether hedging is a cost-effective alternative;
>
> (5) determination of the number of contracts needed to cover the identified exposure; and
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> (6) determination of the change in market value of the futures contracts if there is a 300

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[5] Gap analysis" is a method of determining the extent of interest rate risk exposure. The ALJ's Recommended Decision contains a very thorough explanation of the method of calculation involved. R.D. at 13-14, 76-79. Gap analysis is not the.most sophisticated method for determining interest rate risk, R.D. at 14-15, 79-80, but it is used by FDIC examiners apparently because they can perform the calculations easily based on information provided by the bank, Tr. 78. If the institution being examined has performed a more sophisticated analysis, such as duration or simulation analysis, the examiners will consider the results of that analysis. R.D. at 79-80.

> basis point change in the underlying interest rate of the contracts.

Ex. 13, p. 1. The MOU incorporated by reference the requirements of the FDIC's *Statement of Policy Concerning Interest Rate Futures Contracts, Forward Contracts and Standby Contracts,* 44 Fed. Reg. 66673 (Nov. 20, 1979), *as amended,* 45 Fed. Reg. 18116 (March 20, 1980), *as amended,* 46 Fed. Reg. 51302 (Oct. 19, 1981)("FDIC Policy Statement"). Ex. 13, pp. 6-8. While the MOU reflects and implements the FDIC Policy Statement in many ways, the FDIC Policy Statement contains additional requirements including maintenance of general ledger memorandum accounts or commitment registers to keep an account of the futures contracts and the establishment of internal controls, segregation of duties, and internal audit programs.

d. The Bank's efforts to comply with the MOU

On March 11, 1992, the Bank transmitted to the FDIC a packet of documents apparently designed to implement the MOU. Ex. 15. The most important of these was entitled the *Asset/Liability Policy Management Statement* ("Policy Management Statement"), approved by the board on December 30, 1991. R.D. at 26. It set up the ALCO (although that body had apparently already been set up by the April 23, 1991 Policy) and delegated to it the responsibility for implementation of the Policy Management Statement.[6] With regard to interest rate risk, the

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[6] The ALCO's four members constituted four of the five members of the Bank's board. R.D. at 26.

Bank set a policy of ensuring that an adverse change in interest rates of 200 basis points would not reduce average net income by more than 50 percent. Ex. 15, p. 12. This goal was to be achieved by limiting the three month and one year gaps to a minus 40 percent of assets. *Id.* The Policy Management Statement authorizes the use of financial futures contracts to manage the Bank's exposure to interest rate risks, *id.*, p. 13, and requires the ALCO to perform the determinations and calculations identified in the MOU if financial futures are used, *id.* p. 14.

The March 11, 1992 transmittal also enclosed an unsigned copy of the minutes of the ALCO for February 23, 1992. *Id.*, p. 16. The ALCO minutes included calculations purporting to show that a total of 100 futures contracts would be needed to fully hedge the Bank's liabilities; however, the ALCO determined to maintain the current position of 80 contracts as a sufficient hedge. A signed version of these minutes calculates at 122 the number of contracts necessary to effect a full hedge. Ex. 32, p. 2.[7]

Another document enclosed in the transmittal, entitled *Greene County Bank Interest Rate Strategy,* contained calculations showing that 70 contracts would be adequate to totally hedge the Bank's liabilities for one year. Ex. 15, p. 17. Finally, the transmittal included some regression

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[7] A signed version of the minutes with the 100 contracts calculation also exists in the record. Ex. 21-b-4, p. 2.

analyses showing the high correlation between the T-Bill futures and the Bank's liabilities. *Id.*, pp. 18-21.[8]

Pursuant to the MOU, the Bank submitted monthly reports. R.D. at 102-03. Some of the early monthly reports (prior to November 1992) contain the results of regression analyses concerning the correlation between the Bank's liabilities and the futures chosen as a hedge. Exs. 217, 219, 221, 224, 225. However, the later reports do not include this information although it was apparently available.[9]

The Bank did not calculate interest rate risk on a regular basis during the period at issue; however, it received further information on interest rate risk in the form of gap analyses from Reports of Examination issued by the FDIC and the State of Missouri. R.D. at 39.[10] Moreover, information on interest rate risk and hedging was also presented in an analysis done for the Bank by IBAA Securities in June 1992. Ex. 30. That report contained a gap analysis and concluded that the Bank "give

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[8] KPMG Peat Marwick had previously done a study for the Bank in December 1991 showing that correlation. R.D. at 95.

[9] Beginning in early 1992, Mr. Rullman produced a monthly report (Ex. 279) for the ALCO on his computer that described the Bank's current futures positions, determined gains and losses on the positions, and included a regression analysis. R.D. at 43.

[10] Just prior to the hearing, Mr. Rullman performed an interest rate risk calculation based on proposed federal regulations, *Risk-Based Capital Standards: Interest Rate Risk*, 58 Fed. Reg. 48206 (Sept. 14, 1993). R.D. at 16-19. He also performed other interest rate risk calculations in late 1993 (Ex. 268A, 268B, 268C). Tr. 831.

consideration to reducing the number of T-Bill contracts. . . . it appears that only forty contracts would be needed to hedge your negative gap of approximately $10 million." *Id.* at p 21.[11]

e. The Bank's acquisition of spread positions

As noted above, the Bank began to acquire spread positions in late 1992. The strategy the Bank has pursued appears to leave the basic 80 short contract hedge in place, while the Bank acquired some long and an additional but equal number of short contracts of different maturities from the long contracts. R.D. at 96-97.

Nothing in the policy documents generated to comply with the MOU (Ex. 15) specifically authorizes the acquisition of long futures or of derivative instruments not designed to hedge interest rate risk exposure. The record contains an undated document purporting to justify the initial investment in long contracts as a way of cutting the costs of the hedge strategy. Ex. 21-b-5. Based on that document and the testimony of Mr. Rullman, Tr. 800-04, the strategy for acquiring long contracts and short contracts of differing maturities appears speculative: an attempt to take advantage of the spread between the long and short contracts to create income that could be used to offset the cost of the basic hedge. The acquisition of the

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[11] The FDIC's Examiner-in-Charge for the Bank also testified that the Bank's futures position had remained constant even though its interest rate risk exposure had declined over the period at issue. Tr. 533.

spread positions was not designed to hedge interest rate risk. R.D. at 41-42.

Neither the minutes of the ALCO nor those of the board clearly show approval of the strategy at the time of the initial investment. Exs. 31, 32. The first apparent approval of acquisition of long contracts is contained in the ALCO minutes dated March 29, 1993, several months after the initial investment. Ex. 32, p. 15. Fortunately, the Bank incurred no net losses as a result of these investments. R.D. at 41.

f. Mr. Rullman's role

Mr. Rullman clearly has played the dominant role in the Bank in trading futures and securities. R.D. at 44-45.[12] There is no segregation of duties or internal audit program in the Bank to act as an independent check on Mr. Rullman. R.D. at 45; Tr. 356. At least two sets of the minutes indicate that the ALCO delegated to Mr. Rullman the decision on whether or not to increase the hedge

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[12] The Bank's purchase of a Real Estate Mortgage Investment Conduit ("REMIC") security (more generally known as a collateralized mortgage obligation or CMO) appears to have been arranged by Mr. Rullman without a full-blown analysis or ALCO or board of directors approval. R.D. at 49-50. Under certain circumstances, apparently not present in this case, a REMIC would be a "high-risk mortgage" security and might be an improper investment under federal guidelines. R.D. at 104. *See Supervisory Policy Statement on Securities Activities*, 57 Fed. Reg. 4028, 4037-38 (Feb. 3, 1992). However, the Bank sustained no loss on this investment. *Id.* at 50.

position. Ex. 32, pp. 10-11.[13] Moreover, at least one member of the Bank's board and ALCO committee was unclear about the reason for the increases in the Bank's futures positions. Ex. 27; Tr. 430-32. Up to the time of the issuance of the Notice, however, the hedging program had been successful in controlling the Bank's interest rate risk exposure. R.D. at 99. The spread positions, although not part of the hedging program and, therefore, speculative, have provided income to offset the costs of that program. R.D. 100-01.[14]

4. The ALJ's Decision

The ALJ issued a lengthy and careful Recommended Decision. Most of the facts just set forth are among those found by the ALJ. As noted above, he declined to institute a cease and desist order. With respect to specific investments he concluded that:

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[13] In fact, all of the minutes tend to be very cryptic concerning futures and securities matters, although it is reasonable to infer from the language in the ALCO minutes that the monthly analyses performed by Mr. Rullman using his computer program, *supra*, note 9, were presented at the ALCO meetings.

[14] The Bank's liquidity position has been a matter of some concern. Its short term assets are a small percentage of its short term volatile liabilities, R.D. at 90-91, leaving open the possibility that a decline in deposits caused by rising interest rates could create a liquidity problem. However, the Bank's liquidity position is strengthened by the availability of appreciated securities and credit lines at other banks. R.D. at 50, 91.

(1) the sale of naked call options was an unsafe and unsound practice but had not resulted in losses and had not been repeated, R.D. at 45-46, 106;

(2) the purchase of the REMIC was not an unsafe and unsound practice in that it was not a "high risk security" under FDIC guidelines and resulted in no loss to the Bank, R.D. at 104, 106;

(3) the acquisition of the spread positions, although arguably speculative, offset most of the expenses of the hedging program and was consistent with the Bank's investment policy, R.D. at 40-43, 101; and

(4) the Bank's hedging strategy involving the use of short futures contracts to hedge short-term liabilities was appropriate, effective and entailed little risk to the institution, R.D. at 98, 99.

In addition, he concluded that the Bank was in substantial compliance with the MOU and the FDIC Policy Statement concerning futures: (1) "The bank has complied with the MOU in material respects but it has not adopted an investment policy in full compliance with paragraph 1(c) of that agreement," R.D. at 106, and, (2) the "substance" of the FDIC's Policy Statement on futures had been adopted by the Bank, R.D. at 26. For these reasons he declined to recommend imposition of a cease and desist order.

The ALJ carefully considered the Bank's attempt to comply with each provision of the MOU and Policy Statement. He found that the Bank had policies governing futures investments. R.D. at 23-24. He relied on the Funds Management and Investment Policy approved by the

Bank's board of directors on April 23, 1991, as authorizing investments in futures and setting a limit on the futures of an amount equal to total loans and investments. *Id.* He noted that although the first purchase of short futures occurred without specific board approval, the board apparently discussed and approved subsequent purchases at the September 10, 1991 meeting. R.D. at 24-25. Later, in his view, ALCO became responsible for and did develop policies. R.D. at 26. He also concluded that calculations contained in the ALCO minutes of February 23, 1992, provided limitations on the amount of futures the Bank could acquire and determined the proper hedge ratio. R.D. at 27-30.

The ALJ concluded that the risk to be hedged was adequately identified because of the repeated gap analyses performed by the examiners and IBAA Securities. R.D. at 39-40. He also found that the futures chosen to hedge the risk were appropriate, and that the Bank had performed monthly correlations to verify the continuing appropriateness of the use of those futures. R.D. at 32-33. Finally, with regard to the MOU requirement that cost-effectiveness of various alternatives to reduce interest rate risk be considered, he determined that the other alternatives were not really appropriate or feasible. R.D. at 70.

The ALJ also addressed the requirements of the FDIC Policy Statement. Although most aspects of the FDIC Policy Statement were incorporated in the MOU, at least one important one – the establishment of internal controls, segregation of duties, and internal audit programs to prevent unauthorized trading – is not expressly addressed in the MOU. The ALJ found that Mr. Rullman's

"dominant role in the trading of futures is a matter of legitimate concern to examiners" in light of the FDIC Policy Statement. R.D. at 44. Despite the lack of segregation of duties and internal controls and audit programs, the ALJ found that "futures trading confined to top management, subject to constant oversight by the board [of directors]," to adequately effect the FDIC Policy Statement's requirements that some form of check be established on Mr. Rullman's role. R.D. at 45. In addition, the ALJ concluded that literal application of the requirement was not necessary because it was aimed at larger banks where futures trading was conducted by lower level employees and, in any event, was impossible because of the size of the Bank. R.D. at 44, 45.[15]

DISCUSSION

In its Exceptions, FDIC Enforcement Counsel asks the Board to reverse the ALJ's Recommended Decision and impose a cease and desist order on the Bank pursuant to 12 U.S.C. § 1818(b).[16] It is clear to the Board that some of

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[15] With regard to the liquidity issue, the ALJ, although noting the low percentage of short term assets to short term volatile liabilities, concluded that liquidity did not present a great danger to the Bank because of the availability of the appreciated securities and the Bank's stable deposit base. R.D. at 91.

[16] FDIC Enforcement Counsel, while agreeing with a significant number of the ALJ's factual findings in its Exceptions, expressed disagreement with some factual findings as well as with some of the ALJ's inferences and conclusions. Detailed discussion of the Exceptions would serve no purpose in light of the Board's disposition of this case.

the Exceptions are well-taken and that the Bank is not in full compliance with the MOU and FDIC Policy Statement (this point is not really disputed by the ALJ).

The Board's decision whether or not to impose a cease and desist order based on the Bank's shortcomings involves the exercise of discretion. A cease and desist order is remedial in nature. It is not intended to punish the subject respondent, but rather, to enforce the need for correction of unsafe and unsound practices. In this case, the Board believes, for the reasons stated below, that the ALJ erred in recommending that the discretion be exercised in favor of not imposing some type of cease and desist order.

The Board agrees with much of the ALJ's analysis. It is clear that the Bank chose the right vehicles – short T-Bill and Eurodollar futures – for its hedge and accomplished at least a partial hedge. It is equally clear that the naked call options, spread positions and REMIC investment were not part of the hedging program but caused no loss to the Bank. Moreover, Mr. Rullman appears to have significant familiarity with the securities and futures markets and gave some consideration to these investments prior to engaging in them, even though the Board concludes that some were speculative in nature.

Finally, the Bank did make some effort to comply with the MOU and FDIC Policy Statement. The Bank did initially attempt to address the interest rate risk problem after the February 1991 examination by putting into place the Policy and engaging in hedging transactions beginning in September 1991. At about the time the MOU was signed in February 1992, the Bank had begun to and

continued thereafter to make an attempt to comply with its provisions. It adopted the Policy Management Statement which represented a significant improvement over the Policy. It put the ALCO in place and held regular meetings at which the ALCO received important information concerning the Bank's current futures positions and their correlation with the liabilities the Bank was hedging.

The Bank also began to obtain assistance with its hedging program from outside professionals. In December 1991, KMPG Peat Marwick performed a correlation analysis showing the high correlation between the hedge instruments the bank chose and the liabilities the Bank was hedging. It received further information on its interest rate risk and hedging from IBAA Securities in June 1992.

Finally, the Bank's records do contain information on how it determined the size and nature of some of its futures positions. Thus, the Bank has made progress in addressing the interest rate risk issue.

Nonetheless, this progress should not obscure the haphazard and after-the-fact nature of compliance with the MOU and FDIC Policy Statement and the problems that remain. As discussed below, this case illustrates some of the issues and potential problems with partial compliance with the MOU and the FDIC Policy Statement. Investing in futures entails significant risks. In this case, for example, one position – the naked call options – was completely speculative and exposed the Bank to the risk of substantial losses. The investment in spread positions was also essentially speculative although it exposed

the Bank to somewhat less risk than the naked call options.

In the context of these risky investments, the MOU and FDIC Policy Statement serve two purposes. One is substantive: ensuring that an institution has given careful consideration to all relevant factors prior to making these investment decisions. The other is procedural in the sense of recordkeeping: ensuring that examiners, auditors, and persons within a financial institution are able to ascertain the steps in the decisionmaking process in order to review the appropriateness of the transactions. In addition to the suitability of these investments, there are three critical areas of inquiry: prior approval, documentation, and segregation of duties.

Ultimately, the requirements at issue in this case are analogous to the requirements that apply when a financial institution makes a loan or any other investment: to carefully consider the merits of the investment, to properly document the decisionmaking process, and to have compliance personnel verify these steps. An institution would no more make a loan to a borrower without first considering the borrower's ability to repay, documenting that consideration, and having some independent check on those functions, than it would make an investment in futures for the purpose of hedging without ascertaining and documenting the extent of interest rate risk, and subjecting those calculations to independent verification by auditing personnel. To endorse the Bank's conduct in this case would be to endorse something less than the "prudent person" standard of care required of bankers. This the Board declines to do.

A. Deficiencies in Prior Approval and Documentation

The facts of this case highlight the problems in the Bank's decisionmaking process in effecting its futures investments. Essentially, two problem areas remain: rigor of prior analysis and proper documentation. From the facts, it appears that Mr. Rullman made the crucial decisions on his own, without complete analysis or documentation and, at times, without prior approval by the ALCO and the board. For example, the Bank acquired the first futures on September 9, 1991, yet the February 23, 1992, ALCO minutes are the earliest document in the record purporting to show the calculations justifying the 80 contracts acquired in September 1991. Moreover, none of the ALCO or board minutes justify the naked call options sold at about the same time.

Furthermore, in the fall of 1992, the Bank began to acquire a number of spread positions. However, there is no documentation of approval of such investments prior to the ALCO minutes for March 29, 1993, and, the only document explaining the strategy is undated (Ex. 21-b-5). Despite the ALJ's finding to the contrary, R.D. at 101, the Board cannot agree that the Bank's policies specifically authorized acquisition of long contracts prior to the approval contained in those minutes. Neither the Policy (Ex. 16-b-2) nor the Policy Management Statement (Ex. 15, pp. 9-15) specifically authorizes acquisition of long futures or, indeed, the acquisition of futures for any purpose except reduction of interest rate risk. Moreover, to the extent that these documents contain language that is vague enough to be interpreted as permitting the acquisition of long futures, the Board deems these documents

not to be in compliance with the FDIC Policy Statement's specificity requirements. *See* 45 Fed. Reg. at 18117-118.[17]

In addition, there were changes and increases in the number of futures contracts held despite indications of a decrease in the Bank's interest rate risk exposure. The Bank's records do not disclose any analysis or calculations showing the basis for these decisions. The Board also notes that at least one ALCO member was unclear concerning the reason for the increases.

Indeed, in this regard, it is significant, in the Board's view, that at no time until just before the hearing did the Bank perform calculations of its own to quantify its interest rate risk exposure. The ALJ excused this failure because the Bank received gap analyses measuring that exposure from FDIC and State examiners, R.D. at 39, as well as from IBAA. The existence of these sporadic analyses plainly furnished the Bank important information, but the Board disagrees that the Bank's receipt of these analyses absolves it. In the same way that the Bank, on a regular basis, was monitoring the correlation between the liabilities it was hedging and the hedge instruments, it should also have been monitoring its interest rate risk

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[17] The "net" number of contracts (short minus long) has tended to remain at the basic hedge position of approximately 80 short. This net position, however, is not the same as merely having 80 short contracts in place because the long contracts had different maturities from the additional short contracts. Accordingly, a policy merely permitting the Bank to acquire 80 short contracts to hedge interest rate risk would not also justify, without more, a position of 160 short and 80 long contracts because the second position involves considerations other than hedging interest rate risk.

exposure. The need for more regular monitoring is borne out by the fact that its interest rate risk exposure declined during the period at issue without the Bank making a determination concerning the advisability of adjusting its futures positions. Moreover, if the Bank objected to using gap analysis as too simplistic, it was free to choose any other acceptable method of measuring the risk.[18] The important point was to make sure that the risk was measured regularly in some fashion.

Finally, the ALJ incorrectly excused what can be described as Mr. Rullman's very cursory analysis of the REMIC investment. R.D. at 48-50. Even though Mr. Rullman may have performed some analysis prior to the purchase, R.D. at 49-50, several cryptic notes written on a prospectus, while they appear to address questions concerning the appropriateness of the investment, do not constitute adequate contemporaneous documentation concerning a security that under certain circumstances might be an improper investment under federal guidelines, *supra* note 12.

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[18] Just prior to the hearing, Mr. Rullman performed some calculations of interest rate risk (Ex. 268A, 268B, 268C) as well as an interest rate risk analysis relying on a framework proposed in *Risk Based Capital Standards: Interest Rate Risk*, 58 Fed. Reg. 48206 (Sept. 14, 1993). R.D. at 16-19; Tr. 831. While FDIC Enforcement Counsel has pointed out that the method of analysis proposed in the Federal Register has not yet been finally approved, R.D. at 18-19, if the FDIC and the Bank can agree that the method is appropriate and works, there is no reason it cannot be used. In addition, the Board understands that computer software to perform more sophisticated analyses is readily available.

In sum, despite the Bank's adherence to aspects of the MOU and the FDIC Policy Statement, the Board finds deficiencies in its approval and documentation of its futures transactions. Ultimately, it is difficult for the Board to determine what formal analysis went into the decisions made by the Bank or how, after the initial decision to acquire 80 short contracts, subsequent contracts fit into the policies adopted by the Bank.[19]

The formal requirements of the FDIC's policies and the MOU are not particularly onerous. Prior to a futures transaction, the Bank needs to fully document the decision. At a minimum such documentation must indicate how the transaction is justified by the Bank's policies concerning interest rate risk (or must indicate board approval if the transaction does not fit within the current policies), what the extent of the interest rate risk is, how the size of the transaction is calculated, and how the particular futures contracts are chosen, *i.e.*, the correlation with the liabilities or assets to be hedged. The Bank should be carefully considering these issues prior to the transactions in any event, so reducing them to writing should not be difficult. Indeed, the record contains documents presenting much of this information after the fact.

The Board notes that the prior approval and documentation requirements in the MOU and the FDIC Policy

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[19] This is not to say that the original policies adopted need to foresee every possible futures investment and explain the circumstances under which the Bank may choose that investment or that they can be so vague as to be meaningless. The policies can and must change, and the use of futures should vary with changes in the Bank's interest rate risk exposure.

Statement are crucial to well-informed decisionmaking. They are also important because they permit FDIC examiners and others to evaluate the prudence of the decisions made based on contemporaneous documentation. The failure to adhere closely to these requirements is an unsafe and unsound practice that exposes the Bank to an abnormal risk of loss. Therefore, the Board cannot condone that failure.[20]

B. The Separation of Duties Problem

The problems previously noted in the prior approval and documentation areas take on added significance in this case because of another problem: the concentration of duties in the hands of Mr. Rullman. The ALJ noted this as a legitimate area of concern, but concluded that given the Bank's size and its Board's continuing supervision of these futures activities on a monthly basis, the Bank satisfied, to the extent possible, the requirements of the FDIC Policy Statement that there be an independent review of the decisions made by Mr. Rullman.

Since the issuance of the ALJ's Recommended Decision in October 1994, the international banking community has witnessed a very graphic example of the dangers of concentrating duties related to futures trading in the hands of a single person. One factor in the failure of Barings Bank, PLC, was the concentration of trading,

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[20] The Bank's ability to protect itself using futures was not really tested during the period at issue because of the relatively stable interest rates. It is unclear how the Bank would have fared in a period of more volatile rates.

settling, and compliance duties in a single employee in Barings' Singapore office.

In light of this graphic experience of a violation of the requirements of sound banking practice as set forth in the FDIC Policy Statement, the Board must be particularly sensitive to the added risk presented by the lack of segregation of duties. It would be preferable for the Bank to have more than one person with expertise in the area of futures activities to ensure an independent check on the person conducting those activities. However, the Board realizes that in a small bank it may not be practical to have more than one person with expertise in this area.

Accordingly, the Board will not impose any additional requirements at this time beyond the current mechanism of board review of and responsibility for futures market activities at the Bank. However, the Bank must remember that adhering closely to the MOU and the FDIC Policy Statement concerning prior approval and documentation takes on added significance because the board's ability to perform its oversight function will depend on the information provided to it.

CONCLUSION

For the foregoing reasons, the Board disagrees with the ALJ that the Bank's compliance with relevant requirements is substantially complete and that a cease and desist order is not warranted at this time.[21] In the Board's

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[21] On the liquidity issue, the Board essentially agrees with the ALJ that the presence of a stable deposit base, the readily

view, the failures of compliance in this case constitute violations of the MOU and FDIC Policy Statement as well as unsafe and unsound practices which could threaten the Bank with an abnormal risk of loss. Accordingly, the Board deems it appropriate to issue the following cease and desist order. The purpose of this order is simply to require complete compliance with the MOU and FDIC Policy Statement.

ORDER

It is hereby ORDERED AND DECREED that:

1. Within 30 days of the date this Decision and Order is received by the Bank, the Bank shall furnish documents to the FDIC showing full compliance with the MOU and FDIC Policy Statement. Those documents shall include:

a. The most recent document approved by the ALCO and board governing the Bank's policy for dealing with interest rate risk exposure;

b. Documents showing any futures positions the Bank holds; and

c. Documents explaining how the futures positions are justified by the policy for dealing with interest rate risk exposure including the calculations performed for determining the extent of

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marketable appreciated securities and the lines of credit with other banks render less threatening the mismatch of long term assets and short term volatile liabilities at the Bank. However, it is imperative that the Bank continue to closely monitor its liquidity position. Any change in the status of the securities or the lines of credit could adversely effect that position.

interest rate risk exposure, the number of contracts and the correlations justifying the choice of futures contracts.

2. The Bank shall continue to comply with the MOU and FDIC Policy Statement and shall calculate interest rate risk exposure on a quarterly basis using gap analysis or any other method of analysis on which the FDIC and the Bank can agree.

By direction of the Board of Directors, dated at Washington, D.C., this 1st day of August, 1995.

/s/ Jerry L. Langley
Jerry L. Langley
Executive Secretary

(Seal)

* * *

(b) Cease-and-desist proceedings

(1) If, in the opinion of the appropriate Federal banking agency, any insured depository institution, depository institution which has insured deposits, or any institution-affiliated party is engaging or has engaged, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to engage, in an unsafe or unsound practice in conducting the business of such depository institution, or is violating or has violated, or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the depository institution or any written agreement entered into with the agency, the agency may issue and serve upon the depository institution or such party a notice of charges in respect thereof. The notice shall contain a statement of the facts constituting the alleged violation or violations or the unsafe or unsound practice or practices, and shall fix a time and place at which a hearing will be held to determine whether an order to cease and desist therefrom should issue against the depository institution or the institution-affiliated party. Such hearing shall be fixed for a date not earlier than thirty days nor later than sixty days after service of such notice unless an earlier or a later date is set by the agency at the request of any party so served. Unless the party or parties so served shall appear at the hearing personally or by a duly authorized representative, they shall be deemed to have consented to the

issuance of the cease-and-desist order. In the event of such consent, or if upon the record made at any such hearing, the agency shall find that any violation or unsafe or unsound practice specified in the notice of charges has been established, the agency may issue and serve upon the depository institution or the institution-affiliated party an order to cease and desist from any such violation or practice. Such order may, by provisions which may be mandatory or otherwise, require the depository institution or its institution-affiliated parties to cease and desist from the same, and, further, to take affirmative action to correct the conditions resulting from any such violation or practice.

* * *

Supreme Court, U.S.
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No. 96-708

In the Supreme Court of the United States

OCTOBER TERM, 1996

GREENE COUNTY BANK, PETITIONER

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE FEDERAL DEPOSIT INSURANCE CORPORATION IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly affirmed the authority of the Federal Deposit Insurance Corporation, under 12 U.S.C. 1818(b)(1), to enjoin as "unsafe or unsound" a practice that causes abnormal risk or loss or damage to a federally insured financial institution.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-7a) is reported at 92 F.3d 633. The decisions of the Board of Directors of the Federal Deposit Insurance Corporation (Pet App. 103a-129a) and the administrative law judge (Pet. App. 8a-102a) are unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 7, 1996. The petition for a writ of certiorari

was filed on November 4, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

The Federal Deposit Insurance Corporation (FDIC) insures the deposits of commercial banks, 12 U.S.C. 1821(a), and examines the banks for safety and soundness to protect the nation's financial system and the deposit insurance funds, 12 U.S.C. 1820(b). See generally *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 327, 329 (1963). The FDIC has a variety of tools to carry out its regulatory mission. Critical among those is its authority to issue cease and desist orders to restrain practices that it finds, in the exercise of its expert judgment, to be unsafe or unsound. 12 U.S.C. 1818(b)(1).

Congress first granted the federal banking agencies the authority to issue cease and desist orders to remedy unsafe and unsound practices, and to remove bank directors or officers who had engaged or participated in such practices, when it enacted the Financial Institutions Supervisory Act of 1966 (FISA), Pub. L. No. 89-695, §§ 101, 102(a), 201, 80 Stat. 1029-1030, 1038-1039, 1046-1048. It intended thereby to provide the banking agencies with flexible supervisory tools, so that they would not be limited to placing the affected institution in receivership, terminating its deposit insurance, or letting the problem fester. S. Rep. No. 1482, 89th Cong., 2d Sess. 1, 5-6 (1966); see also *Gulf Federal Savings & Loan Ass'n* v. *FHLBB*, 651 F.2d 259, 263 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982). Congress has not attempted specifically to define or comprehensively to catalogue those "unsafe or unsound practices" that may give rise to a cease and desist order, nor could it effectively do so. The phrase

embodies "a flexible concept which gives the administering agency the ability to adapt to changing business problems and practices in the regulation of the banking industry." *Seidman* v. *OTS*, 37 F.3d 911, 927 (3d Cir. 1994); accord *Groos National Bank* v. *Comptroller of the Currency*, 573 F.2d 889, 897 (5th Cir. 1978) ("The phrase 'unsafe or unsound banking practice' is widely used in the regulatory statutes and in case law, and one of the purposes of the banking acts is clearly to commit the progressive definition and eradication of such practices to the expertise of the appropriate regulatory agencies.").

1. This case involves an administrative proceeding, initiated by the FDIC, arising out of petitioner's use of financial futures. When properly calibrated and monitored, an investment in futures can protect a bank from interest rate risk (*i.e.*, the risk that, when interest rates rise, the rates that a bank must pay its depositors may increase more quickly than the rates that it can charge its borrowers, leading to a decline in its net interest income). A bank can "hedge" against its interest rate risk by acquiring short positions in the futures market, because the value of those positions will rise if interest rates rise, offsetting the increase in the cost of the bank's deposit liabilities. Conversely, if interest rates decline, the short positions will decrease in value, but that loss will be offset by the decrease in interest that the bank must pay to attract and retain deposits. See Pet. App. 107a, 119a.

Although the use of financial futures can protect a bank from interest rate risk, because they are highly leveraged transactions, a bank's investments in futures are fundamentally more risky than its core activity of loaning money to customers. In the event

of a default on a loan, the bank is unlikely to lose much more than the nominal amount of the loan, if that. In contrast, an investment in a futures position can result in a loss many times the amount of the investment. The use of futures therefore requires careful attention to detail and demonstrated technical competence to avoid threatening a bank's financial soundness.

2. a. Petitioner is a small, state-chartered, federally insured bank, with fewer than $20 million in assets. Historically, it has had a significant and unusually high level of balance sheet exposure to interest rate risk, which, notwithstanding the FDIC's repeated admonitions, it made no attempt to address. Pet. App. 106a-107a. Petitioner's failure voluntarily to act to control its interest rate risk exposure led the FDIC in August 1991 to initiate cease and desist proceedings under 12 U.S.C. 1818(b)(1).[1] Pet. App. 108a. The parties settled those proceedings in February 1992 by entering into a Memorandum of Understanding (MOU). *Ibid.* In the MOU, petitioner agreed to develop written policies

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[1] Section 1818(b)(1) provides in pertinent part

> If, in the opinion of the appropriate Federal Banking agency, any insured depository institution * * * has engaged * * * in an unsafe or unsound practice in conducting the business of such depository institution, * * * the agency may issue and serve upon the depository institution * * * a notice of charges in respect thereof. * * * [I]f upon the record made at [a] hearing, the agency shall find that any * * * unsafe or unsound practice specified in the notice of charges has been established, the agency may issue and serve upon the depository institution * * * an order to cease and desist from any such * * * practice.

dealing with interest rate risk exposure and the use of futures to address that risk, and to provide specific analysis and justification each time petitioner used futures to hedge interest rate risk. Petitioner was also required to obtain prior approval from its board of directors of any plan to engage in futures activities, in accordance with an FDIC Policy Statement on the use of futures that was incorporated by reference in the MOU. *Id.* at 3a, 106a-110a. As the FDIC's Board explained (*id.* at 121a):

> In the context of these risky investments, the MOU and FDIC Policy Statement serve two purposes. One is substantive: ensuring that an institution has given careful consideration to all relevant factors prior to making these investment decisions. The other is procedural in the sense of recordkeeping: ensuring that examiners, auditors, and persons within a financial institution are able to ascertain the steps in the decisionmaking process in order to review the appropriateness of the transactions.

b. Although petitioner made an effort to comply with the MOU, significant areas of non-compliance continued to exist. Of particular concern, in late 1992 petitioner began to acquire quantities of long futures contracts and equal quantities of short futures with different maturities. Those "spread" positions were speculative investments, in that they were designed not for hedging risk but instead to create income. Petitioner's use of futures for speculation violated the MOU because, at the time, petitioner had no policy that authorized its acquisition of spread positions. Petitioner's investment in futures spreads was not approved by its board of directors until March

1993, and the only document in the record explaining petitioner's investment strategy was undated. Pet. App. 4a, 113a-114a, 121a-122a.

Petitioner's failure regularly to measure and monitor its interest rate risk also violated the MOU. That failure was particularly significant because calculations done at the time by bank regulators and outside professionals indicated that petitioner's interest rate risk had declined, which suggested that petitioner ought to have been considering a concomitant decrease in its short futures. Short positions that are unnecessary for hedging purposes are speculative; they represent nothing more than a bet that interest rates will rise. Pet. App. 4a-5a, 112a-113a, 123a-124a.

3. In July 1993, the FDIC initiated cease and desist proceedings under 12 U.S.C. 1818(b)(1), asserting that petitioner's conduct in violation of the MOU constituted unsafe and unsound banking practices. Pet. App. 2a. After a hearing, the ALJ recommended that no cease and desist order issue. *Id.* at 8a-99a. In the ALJ's view, petitioner had complied with the MOU in most material respects, and its investment and trading practices were not unsafe or unsound. *Id.* at 99a.

The FDIC's Board of Directors reversed the ALJ's decision. Pet. App. 103a-129a. Although it agreed with the ALJ that petitioner had made an effort to comply with the MOU, the Board concluded that significant areas of non-compliance remained. *Id.* at 2a, 127a-128a. The Board found that petitioner's failure to properly authorize and document its investments in futures violated the express terms of the MOU and the FDIC Policy Statement. *Id.* at 125a. Those deficiencies were serious, the Board explained, both because prior approval and documentation are "crucial

to well-informed decisionmaking," and because contemporaneous documentation permits "FDIC examiners and others to evaluate the prudence of the decisions made." *Id.* at 125a-126a.[2] Concluding that the discrepancies in petitioner's procedures and documentation respecting futures were "unsafe and unsound practices" that exposed petitioner to "abnormal risk of loss," the Board issued a cease and desist order requiring petitioner to do what it had already agreed to do—comply with the MOU. *Id.* at 128a.[3]

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[2] The Board further elaborated (Pet. App. 121a):

> Ultimately, the requirements at issue in this case are analogous to the requirements that apply when a financial institution makes a loan or any other investment: to carefully consider the merits of the investment, to properly document the decisionmaking process, and to have compliance personnel verify these steps. An institution would no more make a loan to a borrower without first considering the borrower's ability to repay, documenting that consideration, and having some independent check on those functions, than it would make an investment in futures for the purpose of hedging without ascertaining and documenting the extent of interest rate risk, and subjecting those calculations to independent verification by auditing personnel. To endorse the Bank's conduct in this case would be to endorse something less than the "prudent person" standard of care required of bankers.

[3] Contrary to petitioner's argument (Pet. 5 n.2), the FDIC's issuance of a cease and desist order directing petitioner to specifically perform its existing obligations under the MOU was a modest corrective action. While petitioner asserts (Pet. 6 n.3) that the FDIC's concerns should have been "dealt with in the regular examination process," petitioner fails to explain how suggestions made in the course of examination would have succeeded when a formal settlement had not. Given petitioner's failure to abide by the MOU, issuance of a cease and desist order constituted an appropriate, and quite measured,

4. The court of appeals denied petitioner's petition for review. Pet. App. 1a-7a. The court held that substantial evidence supported the Board's findings that petitioner violated the terms of the MOU and the FDIC Policy Statement by failing to "document and obtain approval of the acquisition of a number of spread positions," and by failing to "calculate and analyze its interest rate exposure on a regular basis." *Id.* at 4a. It concluded, moreover, that the record contained substantial evidence to support the Board's conclusion that petitioner's "failure to comply with the MOU constituted an unsafe and unsound banking practice, justifying the issuance of a cease and desist order." *Id.* at 5a. The court rejected petitioner's argument that the "unsafe and unsound" standard encompasses only those "practices having a reasonably direct effect on the Bank's financial soundness," observing that, in the Eighth Circuit, it is "well-settled" that "an 'unsafe or unsound practice' exists where the conduct is 'deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to a banking institution or shareholder.'" *Id.* at 6a.

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next step. Although petitioner correctly perceives (Pet. 5 n.2) that a failure to comply with the MOU's modest approval and documentation requirements will now expose it to further and more serious sanctions, compliance with the MOU is entirely within petitioner's control.

ARGUMENT

Petitioner argues (Pet. 7-15) that the court of appeals erred in holding that a bank's practice is "unsafe and unsound," warranting the issuance of a cease and desist order under 12 U.S.C. 1818(b)(1), if its continuance might result in an abnormal risk or loss or damage to the institution. In petitioner's view, a practice may be enjoined as unsafe or unsound only if it "ha[s] a reasonably direct effect on an institution's overall financial soundness." Pet. 7. The court of appeals correctly rejected that standard, which cannot be reconciled with a fair reading of the relevant statutory provisions or the legislative history.

Petitioner correctly observes (Pet. 10-13) that other courts of appeals have adopted a higher threshold for a finding of unsafe or unsound banking practices than that applied by the FDIC and the Eighth Circuit in this case. See *Gulf Federal Savings & Loan Ass'n* v. *FHLBB*, 651 F.2d 259 (5th Cir. 1981), cert. denied, 458 U.S. 1121 (1982); *Seidman* v. *OTS*, 37 F.3d 911 (3d Cir. 1994); see also *Johnson* v. *OTS*, 81 F.3d 195 (D.C. Cir. 1996).[4] Those courts, however, have not analyzed the compatibility (*vel non*) of their formulation of that standard with the overall statutory enforcement scheme. We believe that that analysis strongly supports the Eighth Circuit's ruling, and that, upon a full airing of the issue, the courts of appeals that currently disagree with the Eighth Circuit will reconsider the matter. Because the existing

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[4] Although petitioner also cites *Hoffman* v. *FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990), the court in that case noted the existence of both standards without adverting to any difference or choosing between the two.

conflict among the circuits may be resolved of its own accord, it does not warrant the Court's review at this time.

1. To the extent petitioner suggests (Pet. 7 n.4) that a practice may not be enjoined unless it has already had a substantial adverse effect on a bank's financial integrity, that argument is defeated by the plain text and obvious import of the statute. A practice is "unsafe" if it "exposes to danger" (*Webster's Third International Dictionary* 2509 (1976)); it is "unsound" if it is "not based on proven practice" or "established procedure" (*id.* at 2511). A practice is unsafe or unsound, therefore, if it is imprudent and carries an abnormal risk of harm.

Nothing in the text or legislative history supports petitioner's view that the FDIC was required to prove that petitioner's practices had already had a substantial adverse effect on its financial integrity. Rather, the test is prophylactic in nature. See *Saratoga Savings & Loan Ass'n* v. *FHLBB*, 879 F.2d 689, 693 (9th Cir. 1989). Just as one who drives drunk or at excessive speeds engages in an "unsafe practice" that may be curtailed irrespective of whether he (or others) have already been injured as a result of his conduct, a bank that engages in careless or risky activities engages in unsafe or unsound practices that may be enjoined without regard to whether it (or its depositors or the deposit insurance fund) have to that point suffered losses therefrom. Although the courts of appeals have come to varying conclusions about the magnitude of risk necessary to trigger corrective regulatory action, even the decisions most favorable to petitioner in that regard make clear that a cease and desist order may issue upon a showing of abnor-

mal risk to the institution. See *Seidman*, 37 F.3d at 926-928, 932; *Gulf Federal*, 651 F.2d at 264-265.

2. To the extent petitioner's argument is that a practice may not be enjoined as "unsafe or unsound" unless or until it poses a reasonably direct risk to an institution's financial stability, that argument is also without merit. In considering petitioner's complaints over what it believes to be undue governmental interference in its business affairs, it bears emphasis at the outset that petitioner operates not in any common private sector business, but in "one of the longest regulated and most closely supervised of public callings." *Fahey* v. *Mallonee*, 332 U.S. 245, 250 (1947); accord *United States* v. *Gaubert*, 499 U.S. 315, 333 (1991); *Philadelphia National Bank*, 374 U.S. at 329-330.

In interpreting the phrase "unsafe or unsound," the courts (including those upon which petitioner relies) have looked for guidance to the construction suggested by Chairman Horne of the Federal Home Loan Bank Board in a memorandum submitted to Congress at the time of FISA's enactment. Chairman Horne stated that

> [g]enerally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the *possible* consequences of which, *if continued*, would be an abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.

112 Cong. Rec. 26,474 (1966) (emphasis added).

The standard applied by the FDIC and the court below is precisely that articulated by Chairman

Horne. See Pet. App. 6a (practice need only be one that is "deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss"). Although the Fifth Circuit in *Gulf Federal* recognized Chairman Horne's articulation as "authoritative" (651 F.2d at 264), it departed from that definition by adding its own more restrictive judicial gloss. See *id.* at 267 ("The 'unsafe or unsound practice' provision * * * refers only to practices that threaten the financial integrity of the association.").[5]

The judicial gloss applied by the Fifth Circuit cannot be reconciled with the text and structure of the overall statutory enforcement scheme. In addition to triggering cease and desist orders, unsafe or unsound banking practices may form the bases for removing officers or directors from an institution and/or prohibiting their further participation in the industry. See 12 U.S.C. 1818(e). Because those are more severe sanctions, however, banking agencies seeking removal or prohibition orders must satisfy an "effects" test in addition to proving the existence of unsafe or unsound practices. The agency must show that, as a result of the unsafe or unsound practice, the institution "has suffered or will probably suffer financial loss or other damage," or that "the interests of the insured depository institution's depositors have been or could be prejudiced." 12 U.S.C. 1818(e)(1)(B)(i) and (ii). If, as *Gulf Federal* suggested, a practice could not be deemed "unsafe or unsound" unless it "threatened the financial integrity of the associa-

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[5] The Third and District of Columbia Circuits adopted the standard enunciated in *Gulf Federal* with little independent analysis. *Seidman*, 37 F.3d at 927-928; *Johnson*, 81 F.3d at 204.

tion," proof of an unsafe or unsound practice would necessarily establish the adverse "effect" required to obtain an order of removal and prohibition, rendering Congress's specific requirement of the latter showing for removal or prohibition superfluous.

It is, moreover, difficult to reconcile petitioner's view that a banking agency may enjoin as "unsafe or unsound" only those practices that directly threaten a depository institution's financial integrity with the fact that a banking agency may without question issue a cease and desist order to enjoin a depository institution's violation of any "law, rule, or regulation, or any condition imposed in writing by the agency in connection with the granting of any application or other request by the depository institution or any written agreement entered into with the agency" (12 U.S.C. 1818(b)(1)), irrespective of how minor or technical the violation. See *Oberstar* v. *FDIC*, 987 F.2d 494, 502 (8th Cir. 1993) ("Proof of misconduct alone entitles the agency to invoke its broad Cease and Desist enforcement powers.").

Neither the Fifth Circuit in *Gulf Federal*, nor the Third and District of Columbia Circuits which followed its lead, analyzed the "unsafe and unsound practices" requirement of Section 1818(b) in light of the independent "effect" requirement in Section 1818(e).[6] It would be appropriate under these circum-

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[6] At the time of the *Gulf Federal* decision, the required effect was "that the bank has suffered or will probably suffer *substantial* financial loss or other damage or that the interests of its depositors could be *seriously* prejudiced" by reason of the unsafe or unsound practice. 12 U.S.C. 1818(e)(1) (1982) (emphasis added); accord 12 U.S.C. 1464(d)(4)(a) (1982) (federal savings associations); 12 U.S.C. 1730(g)(1) (1982) (state chartered savings associations). The italicized modifiers were de-

stances for this Court to permit further development of the issue in the lower courts.

3. In any event, further review is not warranted in this case because the FDIC's cease and desist order would have been upheld even in those courts of appeals that currently apply the *Gulf Federal* standard. In those courts, the question is whether the practice, *if continued*, would threaten the financial integrity of the institution. As we have explained, the use of futures for hedging and speculation requires substantial monitoring and analysis. Although petitioner's failure properly to analyze and document its futures market activities with respect to the particular transactions at issue did not in fact result in a net loss to the institution, the FDIC made a predictive judgment that those practices, *if continued*, could lead to an abnormal risk of loss. Pet. App. 126a, 128a. In light of the highly leveraged nature of futures transactions, and petitioner's use of futures for speculation, such losses could well threaten petitioner's financial integrity.

The FDIC's order in this case was also based on its conclusion that petitioner's failure contemporaneously to document its futures activities in accord with the MOU hindered the FDIC's ability to examine and evaluate the prudence of those activities. Pet.

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leted when Congress modified the requirements for removal and prohibition in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183. The legislative history of FIRREA makes clear that the changes were designed to facilitate the banking agencies' ability to obtain removal and prohibition orders. S. Rep. No. 19, 101st Cong., 1st Sess. 374-375 (1989); H.R. Rep. No. 54, 101st Cong., 1st Sess. Pt. 1, at 468 (1989); H.R. Rep. No. 209, 101st Cong., 1st Sess. 444 (1989).

App. 126a. In *Seidman*, the Third Circuit affirmed the Office of Thrift Supervision's conclusion that an attempt to hinder a banking agency's investigation constituted an unsafe and unsound practice, because that course of conduct rendered the agency "unable to fulfill its regulatory function" and "str[uck] at the heart of the regulatory function." 37 F.3d at 936-937. The court held that Seidman's actions, "if continued, would pose an abnormal risk of damage to the agency," thus satisfying the test enunciated in the Horne Memorandum. *Id.* at 937.[7] Petitioner's failure to comply with the MOU likewise hindered the FDIC's ability properly to perform its regulatory oversight function.

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[7] The Horne Memorandum listed as examples of unsafe and unsound practices conduct quite similar to that at issue here: (1) "[D]isbursement of loan funds on construction in progress without proper safeguards for the association's security for the amounts advanced"; and (2) "accounting procedures which fail to show correctly the condition, operation, and trends of the institution, thus providing misleading information for management decisions." 112 Cong. Rec. 26,474 (1966).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

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PETITIONER'S REPLY BRIEF

This reply brief is submitted by The Greene County Bank in support of its petition for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit. Respondent FDIC concedes that a conflict among the circuit courts has developed over the last eighteen years concerning the meaning of the term "unsafe and unsound" in 12 U.S.C. § 1818(b), but urges the Court to decline review because the conflict may resolve of its own accord given more time. This FDIC position denigrates the importance of this core issue of financial institution regulation, and is highly speculative and unlikely. This case is an appropriate one for this Court's resolution of the admitted conflict in the appellate courts.

1. All of the many financial institution regulatory agencies apply the "unsafe and unsound" standard on a daily basis in countless contexts. The appellate courts reviewing the scope of the "unsafe and unsound" standard have adopted two fundamentally different views of the circumstances which warrant regulatory intrusion into a bank's operations through an enforcement action, and that is what warrants review by this Court.

The Fifth Circuit's decision in *Gulf Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Board*, 651 F.2d 259 (5th Cir. 1981), *cert. denied*, 458 U.S. 1121 (1982), provided an authoritative construction of the statutory "unsafe and unsound" standard, holding that it referred to "practices that threaten the financial integrity" of the bank. 651 F.2d at 267. The Eighth Circuit, on the other hand, divined a less rigorous and speculative standard for "unsafe and unsound" which asks only whether a challenged banking

practice "might result in abnormal risk or loss." *First Nat'l Bank of Eden v. Department of the Treasury*, 568 F.2d 610, 611 n.2 (8th Cir. 1978).

In the 1990's, faced with increased regulatory litigation and the resulting task of defining the scope of the statutory standard, the Third Circuit, the District of Columbia Circuit, and seemingly the Ninth Circuit as well, adopted the Fifth Circuit's *Gulf Federal* formulation. *Seidman v. Office of Thrift Supervision*, 37 F.3d 911, 928 (3d Cir. 1994); *Johnson v. Office of Thrift Supervision*, 81 F.3d 195, 204 (D.C. Cir. 1996);[1] *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990). The Eighth Circuit, however, adopted its own earlier *Bank of Eden* precedent in *Oberstar v. FDIC*, 987 F.2d 494, 502 (8th Cir. 1993). This less rigorous Eighth Circuit legal standard was then applied against the Petitioner in this case. Pet. App. 6a.

This is not a minor conflict in the circuit courts, but rather one that involves a legal standard which all financial institutions, their regulators, and increasingly the lower courts, must deal with constantly. Nor is this conflict, as suggested by the FDIC (FDIC Br. 9-10), one that will likely resolve itself. This split in the circuit courts developed over eighteen years (1978-1996), a lengthy period which does not suggest that the conflict will go away of its own accord. Indeed, the FDIC's argument is that the Fifth, Third, District of Columbia, and Ninth Circuits will in effect overrule themselves and follow the Eighth Circuit's lead "upon a full airing of the issue." *Id.*

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[1] In *Johnson*, the Office of Thrift Supervision appears to have accepted the higher standard. 81 F.3d at 201 n.8, 204. That regulatory position is at odds with the FDIC position here.

If the FDIC's suggestion were ever a reasonable scenario, the *Seidman*, *Hoffman*, and *Johnson* courts would have adopted the Eighth Circuit's earlier *Oberstar* and *Bank of Eden* reasoning. That these courts instead chose the Fifth Circuit's *Gulf Federal* standard demonstrates that continued conflict is inevitable.[2] The only "full airing of the issue" that can resolve these significant differences on a recurring and important statutory issue is review by this Court.

2. The FDIC's criticism of the *Gulf Federal* standard as a "restrictive judicial gloss" (FDIC Br. 12), is unpersuasive. Protection of a financial institution's economic stability, and thus against the risk of loss to federal insurance and bank depositors, is the fundamental purpose for having regulatory agencies with broad oversight powers, and the *Gulf Federal* standard does no more than recognize that financial instability is the keystone for finding an "unsafe and unsound" banking practice. The examination process gives the regulatory agencies virtually unfettered access into all aspects of a bank's operations and performance. Most disagreements are resolved during the examination process. If an agency brings formal enforcement proceedings, however, seeking as in this case a court judgment imposing even greater regulatory control, it is sensible and consistent with the congressional intent in 12 U.S.C. § 1818(b) to base such a judgment on a "reasonably direct effect on an association's

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[2] The District of Columbia circuit described the *Gulf Federal* standard as illustrative of "the weight of case law," *Johnson*, 81 F.3d at 204, a statement which does not suggest that the courts will be moving over time to the Eighth Circuit's lower standard.

financial soundness." *Gulf Federal*, 651 F.2d at 264. This is an issue worthy of full consideration and review in this Court.

The FDIC's attempt to contrast cease and desist proceedings under 12 U.S.C. § 1818(b) with removal/prohibition proceedings under 12 U.S.C. § 1818(e) is similarly unpersuasive. This was not the rationale adopted by the Eighth Circuit. Pet. App. 6a. Moreover, that Congress has provided that even greater harm must be shown by the regulatory agency to justify depriving a person of the ability to pursue a chosen avocation than to justify a cease and desist order is hardly a startling legislative choice, but this difference in the two kinds of cases provides no statutory answer to the question on which the circuit courts have split. This issue also deserves "full airing" in this Court.

The FDIC's argument (FDIC Br. 13) that the *Gulf Federal* standard, requiring a reasonably direct threat to financial soundness, cannot be reconciled with the recognized ability to base a cease and desist order on a technical statutory or substantive regulatory violation is again off the mark. The Eighth Circuit did not articulate this theory. Pet. App. 6a. Financial institutions are on fair notice of statutory and regulatory requirements. They are not on fair notice under the Eighth Circuit's speculative standard of what might be considered an "unsafe and unsound" banking practice. This argument also suggests that review in this Court is appropriate.

3. Finally, the FDIC argues (FDIC Br. 14-15) that petitioner would lose this case even under the *Gulf Federal* legal standard. That argument is plainly wrong.

The Administrative Law Judge ("ALJ") found specifically that the petitioner's hedging program did not expose the institution to any abnormal risk of loss. *See, e.g.*, Pet. App. 92a-93a. The ALJ also found compliance in all material respects with the Memorandum of Understanding ("MOU"). Pet App. 94a-95a, 99a.[3] It was only the "recordkeeping" deficiencies that were relied on by the FDIC, Pet. App. 127a-128a, and by the Eighth Circuit, Pet. App. 4a-5a, in affirming issuance of a penalizing cease and desist order under 12 U.S.C. § 1818(b). There is nothing but speculation that these regulatory paperwork complaints could ever pose an abnormal risk to the overall financial stability of the institution, the legal standard in the Fifth, Third, and District of Columbia Circuits, and probably the Ninth Circuit as well. The petitioner is located in the Eighth Circuit, an irrelevant geographic factor which has subjected it to onerous regulatory proceedings that would never have occurred elsewhere in the country. Only review by this Court can address and resolve this admitted conflict among the circuit courts.

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[3] The ALJ noted the differing legal standards, but held that the banking matters complained of by the FDIC did not meet any standard for "unsafe and unsound" practices. Pet. App. 52a-53a.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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